

FROM CENTRAL PLANNING TO THE MARKET

The Transformation of the Czech Economy, 1989–2004

LIBOR ŽÍDEK



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The Transformation of the Czech Economy
1989–2004

Libor Žídek



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LIST OF ACRONYMS

BCPP	Prague Stock Exchange
CEFTA	Central European Free Trade Agreement
CMEA	Council of Mutual Economic Assistance
CNB	Czech National Bank
COCOM	Coordinating Committee on Export Controls
COMECON	Council of Mutual Economic Assistance
CPI	consumer price index
CR	Czech Republic
ČS	Česká státní spořitelna (Czech name of the Savings Bank)
CSK	Czechoslovak crown
ČSOB	Československá obchodní banka (name of bank)
ČSSD	Czech Social Democratic Party
ČSSR	Czechoslovak Socialist Republic
CZK	Czech crown
DIK	holder of investment vouchers
DM	German Mark
EC	European Community
ECB	European Central Bank
EEC	European Economic Community
EGAP	Export, Guarantee and Insurance Corporation
EU	European Union
FDI	Foreign direct investment
FED	Federal Reserve System
FNM	National Property Fund
FRF	French franc
GATT	General Agreement on Tariffs and Trade

GBP	British pound
HDI	Human Development Index
HN	Hospodářské noviny (newspaper)
HUF	Hungarian forint
IMF	International Monetary Fund
IPB	Investiční a poštovní banka (name of bank)
IPF	investment privatization fund
IPO	initial public offerings
KB	Komerční banka (name of bank)
KDS	Christian Democratic Party
KDU-ČSL	Christian and Democratic Union —Czechoslovak People's Party
KoB	Consolidation bank (name of special bank)
LTO	light heating oils
MSZP	Hungarian Socialist Party
NIF	national privatization funds (in Polish privatization)
ODA	Civic Democratic Alliance
ODS	Civic Democratic Party
OECD	Organization for Economic Cooperation and Development
PHARE	Poland and Hungary Aid for Economic Restructuring
PLZ	Polish zloty
PM	Prime Minister
PPP	purchasing power parity
RIF	Restitution Investment Fund
SBČS	Czechoslovak State Bank
SDR	Special Drawing Rights
SITC	Standard International Trade Classification
SPAD	Market for shares and bonds supporting system
SR	Slovak Republic
UNDP	United Nations Development Programme
US	Unie svobody (political party)
USD	American dollar
USSR	Union of Soviet Socialist Republics
VP	voucher privatization
VRCV	internal reproductive price compensation
WB	World Bank
WTO	World Trade Organization

PREFACE

Those of us who lived in postcommunist countries in the 1990s were affected by the phenomenon of economic transformation—a rather complicated process that was accompanied by numerous problems and difficulties. During the transformation decade, the basic economic system was successfully transformed from a centrally planned model to a market-oriented one. This volume presents all aspects of the transformation process.

This book addresses a wide audience, including students, professionals, and the general public—in short, anyone with an interest in this subject. Studying transformation process helps to understand the functioning of the market economy and it is a useful application of basic macroeconomic knowledge.

The nature of the text is a complex analysis of the 1990s. In addition to a general cross-section description, the text also presents case studies. These case studies highlight selected theoretical problems or deal with controversial issues. When dealing with controversial points, I tried to present arguments from all sides. Occasionally, I make a reference to other factors or side with one of the disputing parties. The evaluative judgments are certainly (and inevitably) subjective; nevertheless, they were made after due consideration and based on previous analyses. The text also includes numerous footnotes explaining technical terms and providing supporting figures.

The readers should be familiar with the basic character of the economic cycle or economic development in the Czech economy before they start to read the following pages. The book leads the readers across the overall development of the Czech economy from the backward centrally planned economy to the milestone—the admission of the Czech Republic (CR) to the European Union (EU). We will see that the transformation process was not

easy. In the beginning, the economy fell into a recession that is usually referred to, due to its specific character, as the “transformation recession.” The slump lasted for several years and was followed by a period of relatively strong economic growth between 1994 and 1996. The economy was next affected by the 1997 currency crisis, which lasted for two years. Economic growth was relatively mild in the following years and the economy started to grow more significantly in 2003. Strong economic growth lasted until the 2009 recession. Thus, I can divide Czech economic development into four periods—the transformation recession, economic growth in the mid-1990s, the recession connected with the currency crisis of 1997, and recovery and growth since 1999 till 2004 when I end my analyses. I generally believe that the entry to the EU in 2004 bounds the main part of the transformation process in Central Europe. I will use this division in the following text as the basic framework.

Although the book targets the transformation process, starting our analysis in 1990 would not provide the reader with a complete picture. I need to find the roots of the needs for the transformation that sprang from the previous period. That is why I first concentrate on the situation at the end of the 1980s. The whole transformation process was conditioned by political changes and political development was a key factor in the transformation process. It is impossible to understand the transformation on purely economic ground without the knowledge of political development (Chapter 2).

The next step is to explain what a transformation process is and how to achieve the goals of transformation in Chapter 3. In Chapter 4 I analyze economic policy and key steps taken by the main participators. In this extensive chapter I provide a chronological analysis for the whole transformation period. Attention is paid to all crucial steps of economic policy and to difficult decisions that the reformers had to face. But some of the topics are only mentioned and more thoroughly analyzed in the following chapters—for example privatization process is only sketched because its in-depth analysis is presented in Chapter 7.

How did the economy react to the measures that are described in Chapter 4? What were the economic results that were achieved during the transformation process? I answer these questions in Chapter 5, which provides data about the development of the main economic indicators. Chapter 6 deals with economic indicators that describe the development of the outer relationships (international trade, movement of capital and migration).

Subsequent chapters provide a deeper analysis of selected aspects of the transformation. Chapter 7 analyzes the frequently discussed issue of privatization (and the change of the ownership structure in general). It was one of the key tasks of the transformation process because private ownership in Czechoslovakia at the end of the 1980s was negligible. Denationalization was a necessary condition for the functioning of a market economy.

Banking sector forms the core of a well functioning market economy. Its transition in the Czech case was an enormously difficult and costly process (Chapter 8). Further, the economy cannot function without well-managed companies. The restructuring of companies was thus a necessary condition if the companies were to be able to compete on the international markets. There were many obstacles for the companies and they had to adapt to the new situation. Some of the steps that were taken during the transformation were positive for the companies and others created a burden. In Chapter 9, I analyze the impact of the transformation process on the companies.

I believe that an analysis of the specific transformation steps is necessary but there are other factors with a long-term impact on the ability of the economy to grow—institutions. I see them as broad rules governing the society that can be formal as well as informal. The changes in this institutional environment are analyzed in Chapter 10.

The next two chapters are devoted to transformation development in neighboring countries—Poland and Hungary. I present similarities and differences to the development in the Czech Republic. The evaluation of the overall transformation process is presented in the last chapter, where I sum up achievements as well as mistakes of the transformation process.

I encountered many problems while writing this book and the main ones were related to statistics. Statistical data change over time, in some cases substantially. While reading the book, please bear in mind that the quoted figures are estimates and can vary among different sources. There are foremost problems with the length of consistent data series because it is highly difficult to find relevant and homogenous data that would cover the whole transformation period. The data that I use are in my view the best that can be obtained. Another general issue involves sources. I am afraid that some analysts, especially from outside of the Czech Republic, do not necessarily grasp all the implications and their criticisms tend to be superficial and biased—especially with regard to the economic recession at the end of the

1990s. Conversely, these analysts provide interesting information about the perception of the Czech economy, as well as the country as a whole.

I strived for a balanced coverage of this demanding issue as a whole, and I hope the book will be insightful and enjoyable to read. Now it is up to the reader to judge the fruits of this effort.

The author wants to thank the Faculty of Economics and Administration, Masaryk University, for help and support provided in producing and translating this book.

SITUATION IN CZECHOSLOVAKIA AT THE END OF THE 1980s

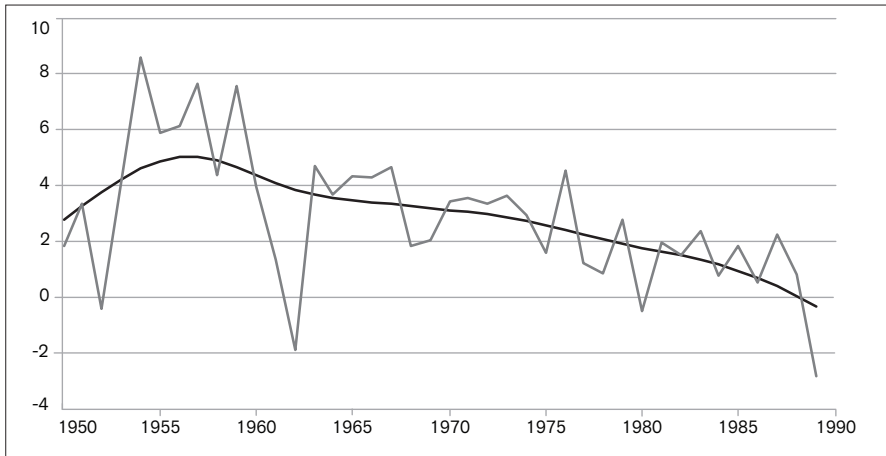
The economic situation was steadily worsening in Czechoslovakia during the communist rule, and became one of the main causes of political changes that took place in the fall of 1989. First of all, I need to analyze the functioning of the centrally planned economy because it was the starting point for the whole transformation process. The initial conditions constituted the basis for measures that had to be taken and also determined the final evaluation of the entire process. I deem the initial conditions as crucial for the development in the whole transformation period. This view corresponds to general institutional theories of path dependence (see, e.g., Furubotn and Richter 2005; North 1990).

Functioning of the centrally planned system was complicated and complex. I try to focus on factors that were in our view crucial for continuous lagging behind of the Czechoslovak economy. This chapter concentrates on the overall view of the economy and society. In several cases (for example, international trade or banks) I describe the starting situation in a more detailed way at the beginning of the subsequent chapters.

1.1 Economic outcomes of the socialist regime

The first question that needs to be asked is: “Was the economic transformation really necessary?” I could use many different measures to show trends in economic activity, the most indicative one being the growth of the economy achieved in the long run without causing unsustainable imbalances—the average or the potential economic growth. Our answer can be seen in Figure 1.1.

Figure 1.1: Economic growth in Czechoslovakia and trend line, 1950–1989



Source: Maddison (2011).

We can see that the growth ability of the Czechoslovak economy was continuously evaporating during the socialist period. The trend line (calculated with the Hodrick–Prescott [HP] filter) shows the development of the potential growth.¹ Its trend is entirely obvious and without doubts down sloping. The economy was able to achieve relatively high growth in the 1950s but this ability was already negligible in the 1980s. The potential growth did not increase even if the establishment occasionally tried to apply at modest economic reforms. The last real attempt took place at the beginning of the 1980s. During the perestroika period only minor changes took place (more on this later in the chapter).²

The causes of the worsening of the economic results lay in the very nature of the socialist economic system. But even in the era of high economic growth (the 1950s), the growth was mainly based on extensive factors that is adding supplementary sources into production rather than improving the effectiveness and productivity (see Půlpán 1993).³ The causes once again had roots in the system itself, where the subjects had no interest in enhancing the effectiveness and struggled for maximizing inputs and minimizing outputs (Holman 2000). As time went by the sources in the economy were exhausted, as was the possibility of extensive economic growth (see Adam 1995). The result was an economy of short supply, where subjects had trouble finding raw materials,

energy, and labor. Among indirect consequences of extensive growth was the high energy consumption, which led to a polluted environment.⁴

The structure of the country's economy was deformed. Communists believed that only manufacturing produced values and therefore focused the efforts on the maximum development of industry, while services—considered to be unproductive by Marxist economists—were neglected.⁵ The Czechoslovak emphasis on industry was exceptional even for a socialist country (see Table 1.1).

Table 1.1: Classification of GDP by sectors in 1990 (in %)

	Agriculture and forestry	Industry	Construction	Services
Czech Republic	8.3	44.6	9.2	37.9
Hungary	6.8	27.3	5.5	60.4
Poland	7.2	35.7	7.0	50.1
Slovakia	5.3	34.7	5.3	54.7
Slovenia	5.6	37.5	4.8	52.1
Romania	23.7	44.1	5.9	26.3
Croatia	10.9	29.3	6.1	53.7
Russia	16.6	38.0	9.6	35.8
Ukraine	25.5	36.1	8.5	29.9

Source: Chvojka (2000).

The industry's internal structure represented another problem. For political, ideological, and superpower reasons, heavy and military industries were preferred,⁶ regardless of the fact that the country had neither suitable raw materials nor sufficient energy basis for such productions⁷ (see Table 1.2). Furthermore, monopoly structures were a typical feature of the Czechoslovak economy.

Table 1.2: Energetic and material demands per USD 1,000 of GDP in Czechoslovakia and other comparable countries (Austria, Switzerland, Belgium, the Netherlands, Finland, and Denmark)

	CSSR	Medium value in advanced countries
Consumption of primary energy (GJ)	20	13.3
Consumption of raw steel (kg)	77.1	27
Cement consumption (kg)	72	36.3
Railway transport (hrtkm)	998	160.2

* hrtkm – Gross tonne-kilometre (hauled)

Source: Pülpán (1993).

Companies and management were not interested in improving the quality of their products. One of the reasons was that almost everything that was manufactured was also eventually sold regardless of their quality. Companies were not under the pressure of competition and the economic environment did not push the management to technological improvements. Real (material) evaluation related to technological improvement was minimal. Insufficient (or problematically targeted) investments meant that the existing machines and equipment were not even renovated.⁸ The result was a permanent technological lagging behind developed countries in most branches. Steiner and Krol quote a study claiming that in 1966, 12 percent of Czechoslovak products were world-class; it was only 2 percent in 1979 (Steiner and Krol 1997). Similarly, Půlpán claims that only 3–5 percent of Czechoslovak products were estimated to be worldclass (Půlpán 1993). Socialist governments were aware of this situation and tried to find a solution; they continuously strove for technological progress (see Faltus and Průcha 1995). However, the general setup of the economic system represented an insurmountable obstacle for this goal.⁹

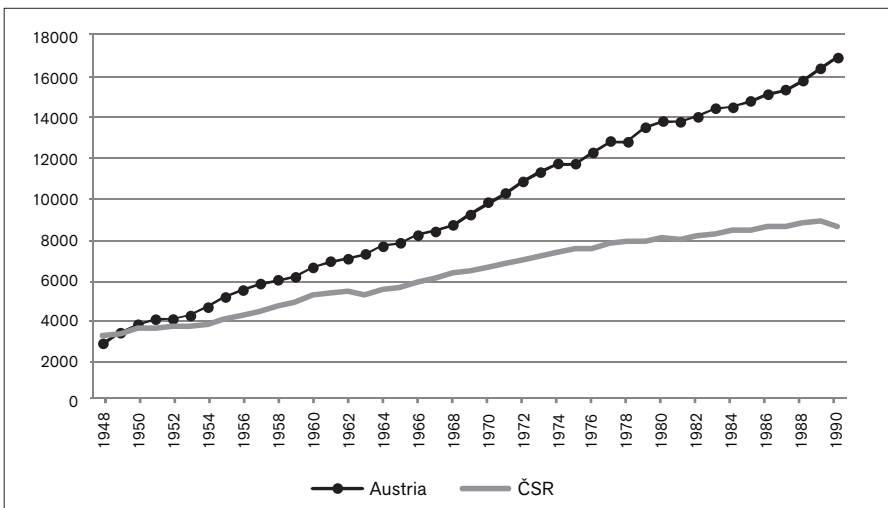
The lack of resources in the economy also surfaced as a hidden debt in the infrastructure—poor railways, roads, and telecommunications. This lagging behind manifested itself in many areas, including accounting standards, marketing, or technologies in general, which were incompatible with western standards.

The Czechoslovak economy suffered numerous structural imbalances, but the level of economic development compared to other Eastern Bloc countries remained relatively high. Czechoslovakia and Eastern Germany were the most advanced countries of the socialist bloc (Tříska 1999). Due to strong social leveling and distribution of wealth and equal distribution of income, there were only a few people living under the poverty line (Tomeš in Dobešová et al. 2003). This situation was reflected, for example, in the weak role that agriculture played in the economy—a positive trait for future development. The roots of this trend date back to the Austro-Hungarian Empire and the prewar democratic state. After 1989, this former industrial glory was perceived as something that should be emulated and restored—historical experience with advanced economy is thought by some economists to have played a positive role in the transformation (e.g., Švejnar 1997).

Conversely, it should be noted that this advanced status was only relative; in other words, it could be considered advanced only when compared to other even more backward countries of the communist bloc. However,

comparisons with the western countries are not flattering. For example, the economic level (GDP [gross domestic product] per capita) in Czechoslovakia in the early 1950s was the same as in postwar Austria. After forty years of communist rule, the Austrian GDP per capita (adjusted to the exchange rate) was five times higher. The United Nations Development Programme (UNDP) quotes the GDP per capita in 1989 at \$3,450 in Czechoslovakia and at \$17,300 for Austria (UNDP 1992). Maddison provides estimation according to purchasing power parity (PPP) and his results favor are more indulgent for Czechoslovakia (Maddison 2010). But the country's GDP per person at the end of the 1980s was less than half compared to Austria (see Figure 1.2). Nevertheless, Czechoslovakia, at the end of the 1980s, was ranked among moderately advanced countries. The 1990 UN statistics—based on the GDP per capita adjusted to exchange rate—ranked the country forty-third in the world (UNDP 1992).

Figure 1.2: GDP per person in Austria and Czechoslovakia, 1950–1989



Source: Maddison (2011).

The real level of the economy and of the entire society is therefore open to question. The perception of the economy by Czechoslovak society was also quite precarious. Myant mentions that Czechoslovak society—including economists—felt that the country's economy was strong and that it was an advanced nation with thriving culture (Myant 2003). Tošovský also points

out exaggerated optimism of some politicians in the early stages of transformation (Tošovský 2000). This resulted in often naive expectations regarding Czechoslovak ability to catch up to western economies within a few years. Klaus disagrees:

The launching of economic transformation was accompanied with widespread optimism. I was often criticized for having “overplayed” this optimism and creating unreal expectations. I am convinced that we had sound reasons to be optimistic and that “optimism is a duty”... Our real limitation at the beginning of transformation could have been naïveté, not optimism. But we were certainly not naive. (Klaus 2000a)

Compared to other Eastern Bloc countries, Czechoslovakia was relatively stable in macroeconomic indexes (e.g., Půlpán 1993). Inflation was modest—both official (open)¹⁰ and hidden. Imbalance between aggregate demand and offer—oversupply of money and shortage of goods—was also lower than in other Eastern Bloc countries (see Adam 1995). As a result, suppressed inflation also remained low (see BOX 1).

BOX 1 Inflation types

.....
Inflation can be divided into three types—open, suppressed, and hidden. Open inflation is usually detected by ordinary statistical measuring. Suppressed inflation means the grounds exist, but the price increase is formally blocked (the state decides to fixate prices). As a result, the market imbalance manifests itself by other means—shortage of goods, lines in stores, or existence of the black market. If the suppressed inflation in the economy remains strong, it results in forced savings because people have nothing to spend their money on. The third form of inflation is hidden, not captured by measurement tools, that is due to configuration of the consumer basket.
.....

Public finances were more or less balanced, resulting in low public debt (17 percent of GDP) and low foreign debt (Hájek 2000).¹¹ The balance of payments was also somewhat balanced (e.g., Faltus, Průcha 1995).¹² One of the goals of the communist regime was 100 percent employment, therefore open unemployment did not exist.¹³ As a result, the economic policy of Czechoslovak communist governments was in line with the long restrictive tradition and led to less dramatic internal imbalances than in other countries (e.g.,

Turek 1995). In general, initial macroeconomic conditions were rather good, yet the stability was achieved at the price of strict restrictions.¹⁴

1.2 Functioning of the socialist system

This section answers the question “What caused the economic erosion?” The main answer lies in the daily functioning of the centrally planned economic system. Yet there are other, more subtle reasons that determined economic growth in the long run—institutions.

1.2.1 Main features of the planning system

There are numerous features that can be considered critical for the functioning of the system. I address the features that I believe were the most important for the state and development of the centrally planned economy as well as for the development during the transformation process.

Economic management

Economy was managed centrally and production was centrally planned. Some scholars argue that even this centrally planned economy was a specific (deformed) form of the market economy (e.g., Mlčoch 1990). Mlčoch claimed that a centrally planned economy as such could not function, because even the widest planning systems were inadequate in relation to the permanently changing needs of the modern economy. It therefore remains disputable to what extent the Czechoslovak economy was planned and to what extent it was a case of the deformed market economy.

Planning was based on the observation of a “factual plan,”—that is in natural units (e.g., pieces or tons), essentially “no matter what it costs” (Brada et al. 1996). There was no competition forcing producers to improve quality. We can even speak of the intention to eliminate competition, which was perceived as a waste of resources (Teplý 1976). The measure of state control was enormous—second only to the USSR (Švejnar 1997)—with the state intervening in all economic areas and not allowing companies any room for

their own initiatives. In this aspect, the situation in Poland and Hungary, where companies enjoyed more autonomy, was very different (see Chapters 11 and 12 in this volume). Table 1.3 sums up how Czechoslovakia lagged behind Hungary in liberalization.

Table 1.3: Chronology of reform measures before 1990

Reform measure	Hungary	Poland	Czechoslovakia
Cancellation of obligatory plans	1968	1982	1990
Cancellation of centralized quotas	1968	1991	1990
First steps leading to liberalization of prices	1968	1957, 1975	1991
Unified exchange rate	1981	1990	1991
Admission to the IMF and WB	1982	1986	1990
Free private enterprises	1982	No restrictions	1991
Bankruptcy law	1986	1983	1991, 1992
Two-stage banking system	1987	1988	1990
New income tax system	1988	1992	1993
VAT system	1988	1993	1991 [<i>sic</i>]
Corporate law	1989	1990	1991
Trade liberalization	1989	1990	1991
Unemployment benefit system	1989	1990	1991

Source: Kornai (1996).

Monopolization of economy went hand in hand with the central system—it was a logical consequence of the government's effort to achieve full control of individual subjects (see Holman 2000; Komárek 1990). Table 1.4 presents the situation in the business sector. Mlčoch notes that while striving to eliminate capitalist monopolies, the socialist government managed to create all-inclusive monopolies with no equivalents in the capitalist world, even in the areas where such a company size did not lead to savings. Companies consequently behaved as monopolies and it was, for example, not uncommon to wait for the installation of a telephone line for ten years.

Table 1.4: Concentration of production in Czechoslovakia in 1990

	100 largest companies	200 largest companies
Total employees (thousands)	878,503	1,250,941
as a percentage of workforce	26	38
Total book value of assets (in billions of CZK)	753	942
as a percentage of total assets of industrial companies	51	63

Source: Frydman (1993).

One of the major economic problems was the fact that the economic center was unable to recognize and estimate demand for individual products. In the market economy, information is provided by prices, but in a socialist system, prices were fixed. This resulted in a surplus of products that nobody wanted on the one hand, and shortages of other products, on the other. Shortages on the supply side were further aggravated by the relationship between the center and the companies that strived for minimum output. The inability to export and thus acquire foreign currency for import of advanced technologies from the West also played its role.

Another problem related to economic management in general existed in the central planning proper. The communist governments considered the central plan to be more effective than a “chaotic” market system (Šulc 1998). Planning penetrated the entire economy in the socialist Czechoslovakia. This practice had numerous downsides. Subjects were not ready or willing to implement changes in production as required by changing demand. Designing plans was very problematic (see BOX 2). In theory, plans were supposed to be for five years, but in reality, planning focused on one-year periods (Půlpán, 1993). Meeting the plan was particularly problematic. As the general economic situation deteriorated, plans gradually “softened,” and requirements toward companies weakened (Holman 2000).

BOX 2 Planning process

Central planning was a complicated process. What steps did it include? Šulc claims it involved three stages (Šulc 2004). The first stage was clarification of development prospects for the next five years (in the center). The main tools used by the center were the so-called inter-branch and inter-disciplinary balances of “needs” and “resources,” both natural (e.g., fuel/energetic balance) and financial or value-oriented (balances of citizen income and spending, division of national product into consumption and accumulation, etc.). Natural balances were confronted with balances of creation and spending of the national product and then mutually adjusted. “Directives for developing (the development) of a five-year plan” were produced subsequently. These directives represented the first version of the plan—they defined relations between basic macro-aggregates, especially the tempo of national product growth, its division into accumulation (investments) and consumption, and so on. They also set tasks for all branches and prominent fields of the national economy (industry, agriculture, building industry, transport industry, internal and foreign trade, and

the nonproductive sphere). These tasks were partly defined in natural units (e.g., coal mining or steel production). In most cases, however, they were expressed in financial aggregates, either in absolute values (volume of production of an aggregated branch), or growth values (planned growth percentage). Centrally planned quantities included planned development of employment, related wage funds, and numerous so-called quantitative indicators (growth of labor productivity, profit, etc.). These central directives were itemized for individual branches of the government, which further itemized them for production-economic units (companies and corporate associations). Centrally formulated tasks had to be transformed into partial tasks—clear and easy to understand for companies (e.g., gross value of production, or wage fund).

In the second stage, production-economic units developed (based on itemized directives) their proposals for the five-year plan—these were summarized by branch ministries and submitted to the central planning authority. Then the second wave of balancing took place, which usually revealed that the proposals of companies differed from the center's proposals. It was followed by negotiations, which often resulted in mutual (but sometimes one-sided) correction of original plans. Then came the final version of the five-year plan (its basic parameters were approved by the parliament as a law). The plan was itemized for individual sectors and production-economic units, and represented obligatory tasks for them.

In the third stage, the planning center, branch ministries and production-economic units worked on annual implementation plans in the same way.¹⁵

.....

Mlčoch, in his profound analysis of the communist system, points out the weakness of vertical forces in economic management (Mlčoch 1990). In theory, the economy was supposed to be managed as a single “huge workshop.” This system was referred to as vertically hierarchical management system—or the so-called department-principle—which was transmission of central decision through several “gears” down to individual companies. Mlčoch proves that despite the grandiose central management intentions, most decisions were taken horizontally—in the form of “supplier–buyer relations” as very specific monopolized markets. He also mentions opposite pressures that evolved in the economy—the so-called principle of “inverted management pyramid,” with its peak in the companies. This principle is based on the fact that the control groups were the principals, while their superiors were the agents, all participants were mutually dependent and interested in meeting the plan’s objectives. This is why companies were able to impose pressure for the softening of the plan’s

requirements. As a result, Mlčoch believes that the pressures of the inverted pyramid prevailed over the management vertical structure and the center thus succumbed to the pressure of individual branches.

Corporate management was used to secure sales, but it had to struggle to acquire sufficient inputs. Purchasing departments were large and purchasers tried to procure sufficient sources for the production. On the contrary, sales departments were small—surplus of money in the economy led to the situation where almost everything that was produced was sold. Advertising and sales promotion departments practically did not exist (see Adam 1995). The management negotiated with the center about the aim to maximize inputs and minimize outputs—the exact opposite of a market economy. There was information imbalance between the center and companies (Holman 2000). The center did not know the companies' real potential and had to negotiate with the management. The system was further deformed by different tax rates and subsidies for individual companies. The economic environment where companies did not face competition while receiving subsidies (and could never go bankrupt) was extremely demotivating. The management was both unwilling and unable to make independent decisions, as it involved personal risks related to potentially bad decisions. The companies' situation was also alleviated by practical competition's nonexistence. The management was not ready to struggle for customers with competitors.

Collective ownership

Furthermore, the economy was influenced by collective (state) ownership.¹⁶ Nationalization after 1948 was brought almost to "perfection" and the private sector practically ceased to exist. The main reasons for nationalization were ideological; communists established the thesis about exploitation related to private property. In addition to ideological causes, economic reasons related to our previous point were also important—state-owned companies are much easier to manage and control from the center. In the 1980s, 87 percent of the GDP was created in state-owned companies, 10 percent in cooperatives, and only 2 percent in the private sector (Tošovský 2000).¹⁷ Only 1.2 percent of workforce was employed by the private sector in 1989. A good example is the number of private farmers—2,000,000 in 1949 and only 10,000 at the end of the 1980s (Tošovský 2000). Mlčoch also points out that despite the formal

equality of citizens regarding property (a constitutional right), there were no real owners of businesses. In practice, economic decision making was in the hands of the state and communist party institutions: these groups were the real owners. Mlčoch claims that the same applies to lower-level managers, down to plant managers. Only employees were excluded from decision making and thus they were not real owners. Mlčoch refers to such economy as “formally collectivized” (Mlčoch 1990).

In comparison, most Eastern Bloc countries did not have such a high level of nationalization, and they were even taking steps to phase out state ownership (especially in Poland and Hungary in the 1980s (see Table 1.3). The situation in Czechoslovakia was very different—reforms in the 1980s were carried out very reluctantly and the government-controlled sector remained practically the same size, although small-scale liberalization (small craftsmen) was allowed (Holub 1996).¹⁸

Position of market subjects: The lack of initiative

Another serious drawback of a socialist economy is related to the previous point—the lack of initiative from the individual market subjects. State ownership, a relatively small chance to influence decision-making processes, and the lack of competition led to a situation where subjects were not interested in meeting customer demands. The economy functioned with soft budget constrain. It means that the companies did not need to achieve good economic results because they were always able to receive money either as subsidies from the government or as bank loans. The companies were not interested in achieving better results because better results led only to tougher plans. As a result, the system tended toward mediocrity, hiding of reserves, and an effort not to get out of bounds (Mlčoch 1990).

It is clear that such a system led to the loss of motivation for (market) subjects. There were no subjects in society looking for new opportunities or gaps in the market and striving for the production’s specialization and rationalization. In other words, nobody performed the functions reserved for entrepreneurs in the market economy (see Kirzner 1998).

As managers were not motivated to be effective, it is no surprise that employees followed their examples. Strong leveling of wages did not help either.¹⁹ Wage differences between qualified and unqualified labor were so

small that it was impossible to remunerate talented and hard-working people or punish those who hardly worked at all.²⁰ As Tomeš notes, these leveled wages were low and thus the entire population had a uniform, low middle-class living standard (Dobešová et al. 2003). Weak motivation demonstrated itself in such slogans as: “We pretend to work, while the state pretends to pay us.” Communists planned to create a “new man” who was supposed to work “happily” and with maximum effort regardless of his pay. No wonder the work ethics of most employees were poor. The state reacted with restrictions—it was illegal to be unemployed and those with no employer stamp on their IDs were treated as parasites.

Foreign trade and economy's openness

Czechoslovak economy was to a great extent closed and protected against foreign influences. Klaus goes as far as to describe it as semiautarchic (Klaus 1994). This view is supported by indexes of openness (e.g., export or import to GDP). The result was a limited influence of the global economy on the Czechoslovak economy. This influence was further distorted by controlled trade, state interventions, and exchange rate (see the following subchapter).

Foreign trade was oriented toward eastern markets—up to 70 percent of all exports were directed to socialist bloc countries (see Půlpán 1993). The CSSR was a member of the Council for Mutual Economic Assistance (CMEA), an institution that organized mutual exchange of products among socialist countries. This organization did not provide a common market (like the European economic area at the time), with free movement of merchandise. Exchange was mediated by bilateral governmental agreements. Near the end of the era, the main reason for directing the trade eastward was the quality of Czechoslovak production, unable to compete in the western markets.²² See Table 1.5 for the geographical structure of the Czechoslovak trade.

Eastern orientation of the Czechoslovak trade burdened its economy with numerous negatives. Exporters sold their products on markets with limited or zero competition.²³ No competing western products were imported to the home market. As a result, the producers were not under any pressure to improve the quality of their production. Such comfortable economic environment was advantageous for the manufacturers in the short run, but in the long run, it contributed to their backwardness.

Table 1.5: Geographic orientation of the Czechoslovak foreign trade in 1975, 1980, and 1985 (in %)

	1975	1980	1985		1975	1980	1985
Export				Import			
Socialist	71.5	69.6	77	Socialist	69.8	70.2	80.7
CMEA	66.5	65.2	72.1	CMEA	65.6	65.9	76.1
Developed capitalist	19.9	21.8	15.7	Developed capitalist	24.6	24.4	15.3
EEC	12.8	13	9.1	EEC	14.3	12.9	8.6
Developing	8.6	8.6	7.3	Developing	5.6	5.5	4

EEC – European Economic community

Source: Půlpán (1993).

Furthermore, foreign trade (like the rest of economy) was centrally planned. There were the so-called foreign trade companies, with monopolies in foreign trade.²⁴ Producers had no direct contact with their customers abroad. Imports from advanced countries were strictly limited due to Czechoslovak inability to export to these destinations. Machinery and other production with higher added value were unable to compete in the western markets, and therefore it was mainly raw materials and semifinished products that were exported.²⁵ This factor is closely related to the technological backwardness. Contacts with advanced markets were limited. Domestic prices on imported products were not based on import prices but established centrally. Consequently, global prices were in no relation to domestic prices. However, restrictions in foreign trade managed to prevent high foreign trade deficits.

The economy was closed according to other indicators as well. Foreign investments in the country were negligible. Půlpán mentions that only 50 companies with foreign share operated in Czechoslovakia, compared to 500 companies in Hungary and Poland. The movement of labor was similarly limited. A limited number of Czechoslovak citizens worked on construction projects in the USSR and other Eastern Bloc countries. People from Vietnam and Cuba worked in Czechoslovakia, as compensation for their national debts.

Distortion of information in the system

In the market economy, information is considered to be the pure necessity of the efficient functioning.²⁶ The market subjects behave according to the information that they have. In the centrally planned economy, information

was completely distorted by the planners and in consequence, the subjects in the economy were confused and unable to make efficient decisions. The distortion of information were expressed in many aspects, foremost in fixed prices. But the environment was further distorted by taxes, the exchange rate, and heavy subsidies.

Prices in the Czechoslovak economy were generally fixed and controlled centrally. See Table 1.6 for several examples of fixed prices.

Table 1.6: Retail prices of selected goods and services in Czechoslovakia, 1953–1988

Type of goods	Unit	1953	1960	1963	1965	1968	1970	1973
Bread	kg	2.8	2.6	2.6	2.6	2.6	2.6	2.6
Rice	kg	28.0	5.0	5.0	5.0	5.0	5.0	5.0
Potatoes	kg	0.6	0.6	0.7	0.7	0.7	0.7	0.7
Butter	kg	44.0	38.0	38.0	38.0	40.0	40.0	40.0
Oil	kg	34.0	25.4	25.4	25.4	25.4	25.4	25.4
Cube sugar	kg	14.0	9.0	9.0	9.0	8.0	8.0	8.0
White wine	l	26.0	19.0	19.0	17.0	17.0	17.0	17.0
Rum (40%)	l	68.0	80.0	80.0	65.0	65.0	65.0	65.0
Pit coal	100 kg	22.4	22.4	22.4	22.4	26.2	26.3	26.2
Man's socks	pair	8.8	4.5	4.5	4.5	4.7	7.0	6.8
Rent (2 rooms)	month	75.0	75.0	75.0	106.0	106.0	106.0	106.0
Electricity	kWh	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Haircut	service	2.0	2.0	2.0	2.5	3.1	5.1	5.0

Type of goods	Unit	1975	1978	1980	1982	1984	1987	1988
Bread	kg	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Rice	kg	5.0	5.0	5.0	10.0	10.0	10.0	10.0
Potatoes	kg	0.8	1.4	1.6	1.6	1.6	1.6	1.6
Butter	kg	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Oil	kg	25.4	25.4	25.4	25.4	25.4	25.4	25.4
Cube sugar	kg	8.0	8.0	8.0	8.0	8.0	8.0	8.0
White wine	l	17.0	17.0	24.0	28.0	24.0	28.0	28.0
Rum (40%)	l	65.0	65.0	83.0	100.0	100.0	100.0	100.0
Pit coal	100 kg	18.6	25.9	25.9	25.9	25.9	25.9	25.9
Man's socks	pair	6.7	11.7	12.8	13.7	14.4	14.0	14.0
Rent (2 rooms)	month	106.0	121.0	121.0	121.0	121.0	121.0	121.0
Electricity	kWh	0.7	0.7	1.1	1.1	1.1	1.1	1.1
Haircut	service	5.0	5.0	5.0	5.0	7.0	7.0	7.0

Source: Statistical Yearbooks of Czechoslovakia (1966–1993).

Prices were fixed nearly permanently. Only when emerging imbalances appeared to be too big, economists enforced “price adjustments” as a rule, which meant increasing prices on a wide assortment of products. But companies used different ways to increase the prices. Brada and colleagues state that companies evaded fixed prices by “pseudo-innovations”—when the same product was sold in a different package for a higher price, or the customer received less for the same price (Brada et al. 1996). For more on price establishing procedure, see BOX 3.

The system with fixed prices meant that prices had no information value for supply and demand sides alike. The price system was even more distorted by tax rates, which were considerably different for individual companies. Take, for example, the turnover tax.²⁷ Table 1.7 depicts various branches and the highest and the lowest tax rates. The negative rate meant subsidy. Thus, for example prices of food or basic needs were supported by the negative turnover tax.

Table 1.7: Turnover taxes in various branches (in %)

Branch code	Branch	Lowest rate (%)	Highest rate (%)
0	agriculture, forestry	-240	66
I	fuels, coal, oil	-189	76
II	heat, electricity	-181	0
III	iron and steel	-33	25
IV	nonferrous metals	-27	33
V	chemicals, rubber, asbestos	-216	71
VI	engineering and hardware products	-291	83
VII	construction material	-171	20
VIII	wooden products	-75	46
IX	paper	-80	52
X	glass, china, ceramics	-69	69
XI	textile	-137	70
XII	clothes	-44	79
XIII	leather, shoes	-222	52
XIV	printing industry and culture	-111	76
XV	food	-224	88
XVI	other industrial products	-100	62
XVII	construction industry	0	0
	combined	-291	88

Source: Heady, Rajah, and Smith (1994).

The total volume of price subsidies was substantial—Hanousek and Krkoška claim it amounted to 3 percent of GDP in 1990 (Hanousek and Krkoška 1997). Kočárník writes that it made up about 11 percent of the budget in 1989 (Kočárník 1990). It involved mainly food, energy, and basic commodities. Kočárník lists several examples of these subventions—1 kilogram of beef was sold for 46 CSK but the subvention was 49.90 CSK; 1 liter of milk—official price 3.10 CSK and the subvention 2.37 CSK, 1 kilogram of butter 40 CSK and the subvention 35.31 CSK; 1 cubic meter of gas cost 1.05 CSK and the subvention was 1.08 CSK (Kočárník 1990). Czesaný writes that in 1990 the state covered in subventions roughly one-third of personal expenditures on nutrition (something like 30 kilograms of meat per person was provided free of charge), more than 65 percent of expenditures on transport, around 60 percent of expenditures on culture, and more than 50 percent expenditures on housing (Czesaný 1990).

The subventions were in line with the general framework, where the prices of durables were relatively high, while the prices of nondurables were relatively low (Fawn 2000). See Table 1.8 for an interesting illustration of this phenomenon.

Table 1.8: Consumption expenses of the Czechoslovak population compared to advanced capitalist countries, 1985

	CSSR	Advanced capitalist
Food, beverages, tobacco	35.5	24.8
Shoes, clothes	11.0	6.8
Rent, fuel, energy	7.2	20.9
Household expenses	14.0	7.6
Transportation	10.5	14.6
Healthcare	0.9	5.9
Culture, education, vacations	4.0	8.3
Other up to 100%	16.9	11.1

Source: Pülpán (1993).

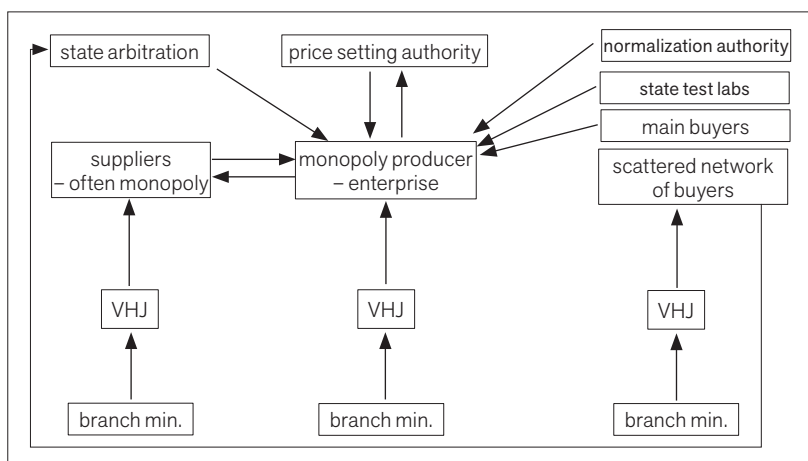
BOX 3 Price establishing

Figure 1.3 offers the price-establishing procedure when a new product was introduced or an old product price was changed.

A monopoly producer introduces a new product trying to get a higher price. He prepares a price offer that must be approved by principal buyers, including technical conditions. In this phase, the producer should already have

the prices of materials, semifinished products, and parts from his suppliers approved. Technical conditions and terms of delivery must comply with technical standards and are assessed by state-run test laboratories. Buyers may resist the new, more expensive product, and this is where the verticals of the supplier and customers come to play in the mutual pressures. With the help of state arbitration, customers may enforce deliveries on old products, or the dead-end situation is solved as a “price dispute” through the price authorities (Mlčoch 1990).

Figure 1.3: Chart for approving a new product and its price in a centrally planned economy



VHJ – Production-economic unit – middle management unit.

Companies were joined and headed by one of the companies or a trust that exercised certain authority above the individual companies.

Source: Mlčoch (1990).

On the one hand, Mlčoch believes that regardless of the effort the planning center cannot isolate prices in individual markets. Still, price distortions led to the confusion of (market) subjects. Producers did not know which products were in demand, while customers did not realize the scarcity of certain commodities (e.g., subsidized prices of electricity or water caused widespread wasting). On the other hand, it is quite clear that even if the producers knew what was in demand, they would still not change their behavior. Another logical result of regulation was the existence of product shortages, long lines, and the black market.

One of the principal prices in the economy is the exchange rate, which was subject to similar distortions as I have already mentioned. In the centrally planned system after the 1960s reforms, the exchange rate had two components—coefficients of the so-called internal reproductive price compensation (VRCV) were added to the official exchange rate.²⁸ Furthermore, the exchange ratio in individual groups of export products was supplemented with a system of price deductions and surcharges. The entire system was further complicated with surcharges on money exchange for foreigners and Czechoslovak citizens alike.²⁹ As a result, there were in reality multiple exchange rates. One of the goals of perestroika was to achieve a single, flexible, and realistic exchange rate. Since 1989, the exchange rate system was reduced to a single component and the VRCV coefficients ceased to exist. In reality, the official exchange rate was devaluated.³⁰ The system of exchange directions was loosened and exporters were allowed to keep a certain proportion of the foreign currencies. They were allowed to sell these currencies on foreign currency auctions that took place during that and the following year.

The overall system was even more distorted by subsidies for companies.³¹ Subsidies played an important role (see Table 1.9). Brada and colleagues add that “insolvency did not have any real consequences for companies, bankruptcy was practically impossible” (Brada et al. 1996). In case of economic problems the company simply received a subsidy. The center thus punished the best companies and used their resources to patch holes in ineffective ones.³²

Table 1.9: Subsidies and transfers to companies: International comparison (% of GDP)

Year	Bulgaria	Czechoslovakia	Hungary
Current expenditures total			
1985	48	51	53
1989	52	55	57
Subsidies and transfers to companies			
1985	13	15	21
1989	15	19	16

Subsidies and transfers to companies include price subsidies for selected products, explicit subsidies for interest rates and debt service for companies and institutions. Subsidies and transfers constitute one component in total current expenditures.

Source: Kornai (1992).

The central bank and banking sector

The banking sector is the backbone of modern economies—it mediates (together with capital markets) the transformation of savings into investments. In Czechoslovakia, the banking sector was centralized and the banking system was one-tier or a monobank.³³ The central bank was subordinated to the government and its activity had to follow the central plan. It had the form of a currency plan, consisting of a loan, cash, and foreign exchange plans. All these plans were based on factual plans and itemized for individual banks (Brada et al. 1996). Tanzi writes about the merging of monetary and fiscal policy: “when the central bank granted a loan to a loss-making company, it also played a fiscal role” (Tanzi 1995). The central bank thus functioned as a cashier, provided cross subsidies to state companies and, according to Tanzi, facilitated tax collecting. The nonexistence of exchangeable currency led to strict separation of internal currency circulation and foreign exchange circulation. From the standpoint of a market economy, the banking and monetary systems were deformed and dysfunctional, while capital markets did not exist at all.

Investments were controlled centrally and bank clerks were not interested in the ability of companies to pay loans or in the credibility of debtors. Companies were simply entitled to get loans. Noneffective allocation of resources was an inevitable consequence. Another typical feature of the financial market in a centrally planned economy was the higher share of cash transactions, especially among people. Loans to citizens were rarely provided and exclusively for approved purposes, such as houses and household appliances.

The situation in the banking sector contributed to a relatively small amount of savings, which later manifested itself in a shortage of capital. Other related factors were low wages, low or negative real interest rates, and the conviction of citizens that the state would take care of them when they grow old or get sick (Tanzi 1995). Conversely, citizens could not possess any financial assets other than bank deposits. The lack of capital in the Czechoslovak economy is discussed by a number of scholars (e.g., Holub 1996; Klaus 1995; Myant 2003; Orenstein 2001; Steiner and Krol 1997).³⁴ One of the few who believed the country had enough savings was Jonáš, who claims that savings in 1990 went up to approximately 50 percent of GDP (Jonáš 1998). The authors of the critical “Report on the state of Czech society” (1999) took a similar standpoint. Describing the state of the Czechoslovak economy in the early 1990s, they observed that “the low share of wages in added value

ensured high levels of national savings and investment, much higher than in other central European countries.” The comparably low level of savings is presented in Table 1.10.

Table 1.10: Domestic savings
(ratio of the growth of saving deposits to financial incomes of citizens, in %)

	1987	1988	1989	1990
Bulgaria	4.2	6.1	2.9	...
Czechoslovakia	3.8	3.0	2.5	...
East Germany	6.1	6.0	4.8	3.0*
Hungary	-1.3	1.5	-0.3	4.7
Poland	7.9	7.8	9.9	...
Romania	...	...	3.7	8.3
USSR**	5.3	6.0	7.4	6.6

*Savings in % of disposable income.

**Data for the USSR in 1989 and 1990 are lower than the data mentioned by other sources.

Source: Tanzi (1995).

1.2.2 Institutions

The preceding text describes the everyday functioning of the centrally planned economy. Its drawbacks are without a doubt among the reasons for worsening economic conditions in the country. But I believe that there are other qualities that determine economic development in the long run—*institutions*. For different definitions of institutions, see BOX 4. We consider as the most important institutions that represent general conditions in the economy and society or, in other words, deep values in the society. Examples of these institutions can be moral situation of the nation, level of corruption, or respect for the law. If there is for example low level of respect for the law, the costs of the functioning of the market subjects increase and it determines their profitability in the long run, and thus also investment and growth.

BOX 4 Formal and informal institutions

Institutions can be defined in various ways. In a narrower sense, institutions are defined simply as organizations—such as financial institutions (stock exchange) or institutions of transformation (e.g., National Property Fund). A wider definition understands institutions as sets of rules. These institutions

can be divided into formal and informal. The former group involves those specified and enforced by the government; for example, the legal system or courts of law. Informal institutions are not defined by the state; these involve customs and morality (Jonáš 1999). Formal institutions can be changed in a relatively short period of time. Informal institutions develop spontaneously, are more stable, and change over longer periods of time. The two types influence each other. Institutions are considered to be of key importance for economic growth in the long run. The state of both formal and informal institutions under socialist rule was not supporting economic growth (see Trřiska 2002) and efforts to change them during transformation were of the utmost importance (for more on this issue, see Chapter 11).

.....

A potential impact of thus defined institutions is more difficult to recognize in comparison to for example the impact of fixed prices. But these institutions in the long run truly influence the potential growth of the country in our view. The state of these institutions in communist Czechoslovakia was a serious obstacle to the functioning of the centrally planned economy. Most important, it was difficult to overcome these “bad values or habits” of the society during the transformation years.

I specifically concentrate on the deep formal and informal institutions that I consider as the most important for the understanding of the communist society as well as the difficulties of the transformation process—the legal and political systems, education, moral climate, dependence, and corruption and the overall lack of knowledge about the functioning of the market economy.

Legal system

The law and the entire judicial system were subordinated to the goals of the Communist Party. Everything was directed to keep this political party in power. The tasks for courts and the prosecutor’s office were to ensure support for the socialist state, social structure, and to lead the inhabitants to devotion to motherland and to the continuous building of socialism. From the economic standpoint, legislation was fully adjusted to support the system of central planning. Laws were different from the ones required for the functioning of a market economy and competition. Furthermore, law enforcement in the

economic area was limited by the small number of market subjects and the fact that, due to central planning, there were few disputes among them. Another key feature of the socialist judicial system was that ownership rights were completely trampled on (Mlčoch 2000). Last but not least, I should mention that the judicial system employed mostly supporters of the regime.

Political system

Political freedom in Czechoslovakia was highly limited. Competition between political parties did not exist and the leading role of the Communist Party was even codified by the constitution. Although other political parties did formally exist, their real influence was minimal. Furthermore, these parties were associated with the so-called National Front, a group of political parties that originated after World War II, with a monopoly on political power. Non-participating parties were not allowed to resume their activities. The National Front was fully subjugated to the Communist Party. Election participation was de facto compulsory and enforced by the state (see Table 1.11). This is how the communist regime tried to achieve a semblance of legitimacy.

Table 1.11: Voter turnout in parliamentary elections, 1954–1986 (in %)

	November 1954	June 1960	July 1964	November 1971	October 1976	June 1981	May 1986
National front ballot	97.89	99.86	99.9	99.96	99.39	-	-
House of people	-	-	-	-	-	99.81	99.97
House of nations	-	-	-	-	-	99.77	99.97

Source: Žaloudek (2004).

Only a small portion of the population—dissidents—exercised active (non-violent) resistance against the regime and strived for plurality of political opinions.³⁵ Thus, the society was not prepared for political negotiations, competition among political parties, and searching for compromise, typical for democratic political systems. Czechoslovakia, in the second half of the 1980s, was conspicuous for its deep political lethargy. While Hungary and Poland underwent political loosening in reaction to perestroika in the Soviet Union, Czechoslovak leaders did their best to avoid any reforms. The main reason was the fact that most of them ascended to power after the 1968 Soviet

occupation and the suppression of the Prague Spring (Šulc 1998). Then they fully embraced the policy of the so-called normalization characterized as the effort to get rid of everything related to the previous reforms, strict thought control, and economic centralization (Dillon and Wykoff 2002). If the leading communists were to embrace perestroika, they would be forced to act against their very nature. Regardless of the causes, it is apparent that the political situation was inert, numb, and closed. According to Adam, traveling restrictions in Czechoslovakia, as well as freedom of expression and research, were stricter than in Poland or Hungary (Adam 1995). Still, the communist government in the 1980s was being put under pressure due to internal criticism, changes in the USSR, and economic underdevelopment. It is interesting to note that the weak government was seen as the main cause of the fall of the regime in a public survey that was carried out in 2009 (see Table 1.12).

Table 1.12: What was the cause of the Velvet Revolution?

Bad government (people refused the discredited communist government of the normalization period)	23%
Decline of the regime (the regime was exhausted and disintegrated due to its nonflexibility and incapability change, reform itself)	18%
Desire for freedom and democracy (getting rid of the totalitarian regime, dictatorship, one party governing, change of the political system, free elections, free life, traveling, freedom of speech, etc.)	17%
Outer causes (decay of the eastern bloc, loss of the foreign support of the regime, Gorbachev reforms, following the development in neighboring countries)	13%
People's revolt (people arose in support of protesting students, demonstrations, people stopped being suppressed and worried)	6%
Economic causes (economic and social crisis, lagging behind the world, debts, lack of goods, queues, necessity of economic reforms)	3%
Staged coup (guard-changing, it was not a revolution)	2%
Dissident activity	2%
Restoration of capitalism (getting rid of socialism and communism in Europe ...)	1%
Ownership changeover (change in the property ownership, private ownership, privatization)	1%
Interest of the west (everything was organized by western countries)	1%
Different opinions	3%
Do not know	10%
All together	100%

Source: CVVM (2011).

Table 1.13: Membership in the Communist Party of Czechoslovakia
and the share of its members in the population, 1949–1981

Date	Membership	Total number of inhabitants	% of population
1949	2,300,000	12,782,002	18.0
1954	1,489,234	12,675,096	11.7
1958	1,422,199	13,343,750	10.7
1962	1,680,819	13,860,704	12.1
1966	1,698,002	14,296,123	11.9
1967	1,689,207	14,296,123	11.8
1968	1,690,977	14,296,123	11.8
1969	1,671,637	14,296,123	11.7
1970	1,535,537	14,486,847	10.6
1971	1,194,191	14,486,847	8.2
1976	1,382,860	15,024,708	9.2
1981	1,538,179	15,374,602	10.0

Source: Dějiny KSČ v datech (1984).

Party membership was in most cases among the basic conditions for career promotions. In the economic area, the political situation was apparent in the selection of higher managers, who were chosen principally from Communist Party members (Mlčoch 1990).

There is only limited information about the number of members of the Communist Party during the communist reign. A sharp decline in the membership after 1968 is evident, when half a million people left the communist party (see Table 1.13).

Education

Education was one of the areas the former regime paid considerable attention to. In particular, technical fields were considered to be state-of-the-art (Fawn 2000; Jonáš 2000; Slaný 2003; Švejnar 1997).³⁶ However, it must be noted that the level of education in the former Czechoslovakia was often overrated. Some fields, including economics were entirely neglected—often for ideological reasons—and lagged behind developed countries. Taking into consideration the educational process as a whole, I must admit it certainly did not teach students individualism and independent thinking. Individuality was suppressed, while everyone was forced to study subjects related to the ruling

ideology of Marxism-Leninism, which infiltrated numerous fields of knowledge, especially the humanities.

Informal institutions: Moral climate, dependence, and corruption

Since elementary school, Czechoslovak children were officially taught that the 1968 Soviet intervention freed the country from a counterrevolution, while at home they learned that the armies came to suppress freedom and the country was occupied.³⁷ The whole nation was forced to live in a lie. It was obvious that having one's own opinions did not pay, because one could have his/her career ruined (a better scenario) or be jailed. Most people did not care about politics or tried to avoid it by any means. To sum things up, the moral decline from fifty years of totalitarian regimes left indelible marks on the population.

Another striking aspect of that era was the lack of independence. The socialist state was extremely paternalistic and people thus lived their lives convinced that the state had to take care of them “from the cradle to the grave.” Tanzi comments on this topic as follows:

The financial wage is much lower than the total reimbursement. A large portion of the total income comes in the form of subsidized rent, free education and healthcare, subsidized transport, food and vacations. In other words, numerous individual consumer decisions are done by the state (or the state company for which he/she works). (Tanzi 1995)

This aspect was closely related to the leveling of income and practical endeavor of the regime to make everyone mediocre. The effort manifested itself in widespread jealousy and envy toward those who stepped out of the line of this mediocrity in any manner.

In addition to these deformations and problems, I should not forget to say a few words about the overall social climate. Popular slogans like: “those who do not steal, rob their families” were widespread. Corruption and bribes were omnipresent, even when buying such daily commodities as meat or fruit. Fassmann quotes surveys among Czechoslovak inhabitants (Fassmann 2007). The shares of people that admitted giving a bribe in the previous twelve months were as follows: 1979—34 percent, 1981—32 percent, and 1989—52 percent. At the same time, even the relative size volume of bribes to wages

was increasing. In the 1980s, people complained foremost about corruption in retail—58 percent, health service—45 percent, services—34 percent, and education—13 percent.

Ignorance

Our previous considerations concerning the lack of independence were related to ignorance in general; it was omnipresent. From an economic perspective, practical ignorance of free market economy was quite staggering. Popular notions of the functioning of advanced economies bordered on total naïveté. This is not surprising considering that even economic majors were taught Marxist economics almost exclusively. At the beginning of transformation, people with sound knowledge of market system mechanisms were very scarce. But at the same time, there was a general conviction of relative development of the country and society.

Furthermore, this is just the tip of the iceberg, as the economy entirely lacked numerous professions closely related to market economy. The socialist countries did not have (and did not need) tax collectors, as there were practically no tax evasions. There were few lawsuits between companies and therefore few judges capable of deciding them. No tax advisors and auditors; no marketing experts or capital market professionals. Loan officers were granting loans as instructed by state organs, without checking the clients' solvency. Accounting systems were deformed and there were no experts on standard western accounting, and I could go on and on, *ad infinitum*. These facts played an important role in the ensuing period of transformation.

Yet, in some aspects, the situation on the starting line of transformation was favorable for Czechoslovakia. Reformers did not inherit an entirely disrupted economy with huge macroeconomic imbalances (as in Poland). Geographic proximity of western markets also played a positive role, as well as relatively qualified workforce. However, negatives prevailed. Most problems stemmed from the economic system itself, namely centralized control and planning. Subjects were not motivated to consider effectiveness and innovation, which was due to state ownership; they lacked information about the market situation because prices were fixed; their autonomy was negligible—they were controlled from the center. Foreign trade was artificially oriented on eastern markets, which contributed to weak competition on the

domestic market. The banking sector lacked independence and simply carried out directives from the center. The economy's structure was deformed by excessive emphasis on industry, among other factors. Long-term social trends—the state of (informal) institutions and the moral climate in the society—should not be neglected either. It is therefore arguable whether Myant was right in claiming that Czechoslovakia had the best point of departure from the entire Eastern Bloc (Myant 2003).

It follows from the previous considerations that some characteristics of the environment were quite easy to change—to liberalize prices, for example. Other things—such as the moral climate in the society or other informal institutions—could only be changed slowly and with great difficulties. In these areas, the point of departure represented a massive obstacle.

Notes

- ¹ There are a few different methods of counting the potential product. Using the HP filter is one of them.
- ² Perestroika was the term attached to the attempts by Mikhail Gorbachev to introduce political and economic reforms in the second half of the 1980s.
- ³ Economic growth can be generally extensive or intensive. The former is based on increasing inputs, the latter on better use of the existing resources. It is always a combination of both in practice. In Western countries, the intensive component of the economic growth has always been more important than in the socialist countries.
- ⁴ At the end of the 1980s, energy consumption per GDP unit was three times higher than the OECD average (Černá et al. 1997). They also claim that one-third of all forests and 60 percent of rivers were heavily damaged during this period.
- ⁵ In 1990, the GDP consisted of the following: industry—48.7 percent, construction industry—5.2 percent, agriculture—8.6 percent, and services (e.g., banking sector, travel services or insurance)—37.5 percent (Holman, 2000).
- ⁶ Military spending in the USSR in 1990 was estimated at 25 percent GDP, while in Hungary, Poland, and Czechoslovakia it was 8 percent GDP (Turek 1995).
- ⁷ Adam quotes that for exporting 1 kilogram of machinery in 1970, a Czechoslovak exporter received on average 58.7 percent of Austrian export. In 1985, this ratio went down to 25.8 percent (Adam 1995).
- ⁸ Půlpán claims that in 1989, the medium age of machinery was eleven years and the degree of wear was 57 percent (Půlpán 1993).
- ⁹ The Western embargo on exports of advanced technology to socialist countries, organized by the Coordinating Committee on Export Controls (COCOM) also played its role in the technological lag (see Bálek 1998). The primary goal of the embargo was, however, to prevent export of militarily applicable technologies.
- ¹⁰ The cost of living index increased only by 24 percent between 1970 and 1989 (Myant 2003). In comparison, in Poland, annual price increase in autumn 1989 amounted to 640 percent (Orenstein 2001).
- ¹¹ In general, governments in centrally planned economies were subject to soft budgetary restrictions, meaning that budgetary deficits were covered by issuing of bonds and/or non-returnable loans from the central bank (Brada et al. 1996).
- ¹² By contrast, Poland was unable to pay its foreign debt in the 1980s (Orenstein 2001).
- ¹³ The situation in the labor market was strongly imbalanced. Many branches suffered from a lack of employees while numerous other sectors were over-employed (Slaný 2000)—estimated at up to 15 percent of workforce by the IMF experts (Weigl 1992). Another typical feature of Czechoslovak labor market was its high level of

participation—that is, the percentage of population that was employed (Adam 1995; Michal 1994).

- ¹⁴ In other countries, these imbalances occurred especially in the 1980s. But the Czechoslovak government decided to keep the balance at the expense of economic growth (Půlpán 1993).
- ¹⁵ For more on planning and the central management system, see e.g., Šulc 2004.
- ¹⁶ There were four basic types of companies in the CSSR—state companies, cooperatives, foreign trade companies, and community companies.
- ¹⁷ But the numbers about the size of the private sector varies.
- ¹⁸ Licenses for small businesses were granted only to properly employed people, who carried out their business activities in their free time (Holub 1996).
- ¹⁹ In 1986, Czechoslovakia had the lowest income inequality in the entire Eastern Bloc—the Gini coefficient was 19.7; Hungary—22.1; Poland—24.2; Russia—27.6; and Great Britain—26.7 (Gros and Steinherr 2004).
- ²⁰ Any existing income inequalities were ideological; for example coal miners' income (a preferred sector of heavy industry) in 1989 was 51 percent higher than the national average (Myant 2003). On the contrary, the lack of employees in some branches or areas, combined with the impossibility to attract them through higher wages, forced companies to offer for example free apartments and subsidized rents (see Soulsby and Clark, 1996).
- ²¹ Export to GDP ratio in 1987 was 19.4 percent which, considering the relatively small economy, is a small number (Michal 1994).
- ²² Weaknesses of Czechoslovak export are described by Půlpán who claims that in 1983, Czechoslovak producers received only USD 1.83 per 1 kilogram of machinery, compared to 2.2 CMEA mean value and USD 7.31 in developed countries (Půlpán 1993).
- ²³ Furthermore, exports were often subsidized or even paid for by the state if deemed politically important, especially exports to underdeveloped countries with socialist leanings. Those countries' debts often turned out to be irrecoverable.
- ²⁴ In 1990 there were only fifty-two companies engaged in foreign trade in Czechoslovakia (Dillon and Wykoff 2002).
- ²⁵ Planners were desperate to obtain foreign currency, often by subsidies. In 1988, replacement costs for foreign currency—that is expenses for acquiring a foreign currency unit ranged from 2.35 CSK to 144.21 CSK per dollar. Average replacement costs based on wholesale prices were 18.11 CSK per dollar (Jirges and Plchová 1996).
- ²⁶ For the meaning of prices see Friedman (1993) or Hayek (1993).
- ²⁷ There were approximately 1,500 different turnover tax rates in the economy (Klaus 1991).
- ²⁸ The VRCV coefficients were calculated from mean replacement costs for the foreign currency acquirement—that is sort of average converted price. The calculation was

based on the average wholesale price and the average retail price in dollars. If the resulting ratio was 21.60 CSK per dollar and the official exchange rate was set at 7.2 CSK per dollar, the coefficient would be 3 (Jirges and Plchová 1996). Note that in this book I use direct quotation of the exchange rate—it means that the exchange rate is expressed in amount of crowns needed for a single unit of a foreign currency; for example, 21 crowns per USD. The indirect quotation is used, for example, in the United States. It would mean that 1 crown corresponds to 1/21 of USD.

²⁹ E.g., the official exchange rate for incoming tourists was 3CSK per DM. Then there was a surcharge of 75 percent, balancing the unreal exchange rate. Czechoslovak citizens had to pay a 125 percent surcharge, in the effort to decrease demand for foreign currency. Furthermore, Czechoslovak citizens had to acquire a special administrative license to be able to buy foreign currencies (Jirges and Plchová, 1996). Ordinary people had therefore only a highly limited chance to obtain convertible currencies (possibly a foreign-based relative might send it to them). Conversely, the government tried to acquire every dollar and it was one of the reasons for the establishment of special shops—Tuzex— where Western goods were offered but customers had to pay only in convertible currencies or special vouchers that were used instead of convertible currencies.

³⁰ Depreciation against freely convertible currencies was done by the coefficient of 2.75—the price of DM increased from 3 CSK to 8.25 CSK in noncommercial payments, while in tourism, the coefficient of 1.75 raised the price from 11.80 CSK to 20.65 CSK per DM (Jirges and Plchová 1996).

³¹ Apart from direct subsidies, numerous public subsidies were implicit, provided through subsidized interest rates, overvalued exchange rate for selected imports, granting of land for certain activities for free or low prices, providing of cheap energy, buildings, etc. (Tanzi 1995). These subsidies are not included in fiscal statistics.

³² Teplý mentions the example of a former Baťa shoe company—a plant that exported 11,000,000 pairs of shoes and paid 500,000,000 CSK in taxes, but its profit was only 15,000,000 (Teplý 1976).

³³ In 1989, laws were passed that led to a two-tier banking system, effective January 1, 1990.

³⁴ Later, the shortage of capital became an important factor in the choosing of privatization methods.

³⁵ Václav Havel played the leading role among the dissidents. His political activities resulted in multiple imprisonment (5 years in total).

³⁶ The Czech workforce was educated and on par with German and Swiss workforce. The percentage of academically educated workforce in Czech Republic was quite high—9.2 percent (6.8 percent in Slovakia) while the ratio of qualified blue collars was 38.1 percent (19.7 percent in Slovakia) (Gitter and Scheuer 1998).

³⁷ The Soviet Army stayed in the country until June 1991.

POLITICAL DEVELOPMENT

Political development played a key role in the entire transformation process. If the population was not persuaded to accept the idea of economic system change, or if this support was lost early, the chance for the process's success would be minimal. In this chapter I map the political development of the entire period according to election cycles. To better understand this process, it is important to become familiar with the main politicians that were active during the transformation period (see BOX 5).

BOX 5 Who is who in the Czechoslovak transformation

-
- Václav Havel (1936–2011)—playwright, president of Czechoslovakia (1989–1992), president of the Czech Republic (1993–2003)
- Václav Klaus (1941–)—economist, president of the Czech Republic (2003–2013), prime minister of the Czech Republic (1992–1997), minister of Finance of Czech and Slovak Federative Republic (CSFR) (1989–1992), chairman of the Civic Democratic Party (1991–2002)
- Josef Tošovský (1950–)—economist, prime minister of the Czech Republic (1997–1998), governor of the Central Bank (1989–2000), chairman of the Financial Stability Institute at the Bank of International Settlements (2000–)
- Miloš Zeman (1944–)—economist, president of the Czech Republic (since 2013–), prime minister of the Czech Republic (1998–2002), chairman of the Czech Social Democratic Party (1993–2001)
- Vladimír Špidla (1951–)—politician, prime minister of the Czech Republic (2002–2004), European Commissioner for Employment, Social Affairs & Equal Opportunities (2004–2010), chairman of the Czech Social Democratic Party (2001–2004)

- Vladimír Mečiar (1942–)—politician, prime minister of Slovakia (1993–1994, 1994–1998), prime minister of the Slovak Federal Republic (1990–1991, 1992)
- Alexander Dubček (1921–1992)—politician, 1968 secretary general of the Communist Party of Czechoslovakia, chairman of the Federal Assembly of the ČSFR (Czech and Slovak Federative Republic, 1989–1992)
- Ivan Kočárník (1944–)—economist, minister of finance of the Czech Republic (1992–1997)
- Vladimír Dlouhý (1953–)—economist, minister of industry and trade of the Czech Republic (1992–1997), minister of economy of the ČSFR (1989–1992), vice chairman of the Civic Democratic Alliance
- Tomáš Ježek (1940–)—economist, minister of privatization in the Czech government (1990–1992), chairman of the National Property Fund (1992–1994)
- Josef Lux (1956–1999)—politician, minister of agriculture (1992–1998), chairman of the Christian and Democratic Union—Czechoslovak People's Party (1990–1998)
- Marian Čalfa (1946–)—lawyer, prime minister of Czechoslovakia (December 10, 1989–1992)
- Zdeněk Tůma (1960–)—economist, governor of the Central Bank (2000–2010)
- Karel Dyba (1940–)—economist, minister of economic policy and development (1990–1992), minister of economy (1992–1996)
- Jan Stráský (1940–)—prime minister of Czechoslovakia (July 2, 1992–December 31, 1992), minister of transportation (1993–1995), minister of health (1995–1996)

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In February 1948, the communist dictatorship was established in Czechoslovakia and it lasted until 1989 (for more on political development during this period, see Tigrid 1990). In November 1989, after mass demonstrations in Prague and other cities, the government resigned and the Communist Party leadership agreed with the opposition (represented by the Civic Forum) to establish a government of national unity. The main task of the government of national unity was to lead the country to free elections. The new head of the state—President Václav Havel—was elected at the end of the year.

The first free elections since the fall of communism took place in June 1990 and were largely perceived as a referendum on the previous regime. The result was a clear victory for the proreform movement.¹ The Civic

Forum—an organization that comprised a wide spectrum of reform groups from “the men of 1968” to “Thatcherite” liberals—won in the Czech Republic.² A movement called “Public Against Violence” won in Slovakia (see Table 2.1). There were three governments in Czechoslovakia at that time—the Federal, the Czech and the Slovak. Due to the electoral system the governments are usually formed by several political parties that create a coalition (see BOX 6).

Table 2.1: Results of elections to the Federal Parliament in June 1990

		House of People		House of Nations	
		% vote	mandates	% vote	mandates
Movement for autonomous democracy party for Moravia and Silesia	CR	7.89	9	9.10	7
Communist Party	CR	13.48	15	13.80	12
	SR	13.81	8	13.43	12
Christian Democratic Movement	SR	18.98	11	16.66	14
Christian Democratic Union	CR	8.69	9	8.75	6
Civic Forum	CR	53.15	68	49.96	50
Slovak National Party	SR	10.96	6	11.44	9
Coexistence and Hungarian Christian Democratic Movement	SR	8.58	5	8.49	7
Public Against Violence	SR	32.54	19	37.28	33
Other	CR	16.79	-	18.38	-
	SR	15.08	-	12.19	-

Source: Žaloudek (1996).

The Civic Forum, a wide coalition of political movements, disintegrated in 1991, and the Civic Democratic Party (ODS), headed by Václav Klaus, was established as its main heir.³ In addition to personal and ideological disputes, the themes of politics without political parties and of civic society emerged as important issues in this time, and remained a matter of controversy between both leaders (Klaus and Havel) during the entire transformation era.

BOX 6 Electoral system

The president plays mostly ceremonial role in the Czechoslovak political system. In consequence, the executive power is mainly in the hands of the government. The Czechoslovak electoral system for parliamentary elections, based on proportional representation, dates back to the prewar republic, and

it was restored after 1989. Elections are held in large multiple-mandate precincts, where the mandates are allocated to individual ballots in proportion to their vote percentage (the system, with slight modifications, is used in most western European countries). The alternative is the majority system (used, e.g., in Britain or in the CR in the Senate elections). Elections take place in small single-mandate precincts and the candidate who gets the majority of votes wins (Žaloudek 2004). The electoral system in itself is vital for carrying out of any economic and political changes. The former system leads to government coalitions, as no party is (usually) able to acquire majority in the parliament. In this electoral system, small parties play an important, sometimes decisive role in the government formation. The latter system tends to create two major parties (e.g., Great Britain) which take turns in power. This system (usually) does not create government coalitions and the government is stable throughout the entire term. Moreover, smaller political parties have practically no chance of pushing through their policies. Reforms are therefore easier to enforce in the majority system with a single party government.

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The first two years were more or less characterized by political disputes between Czech and Slovak politicians. These involved the name of the country—the so-called hyphen war;⁴ while Slovak deputies disapproved of the president Václav Havel⁵ and disputed the competences of national and federal governments. In addition, there was a clear effort to steer the country toward the European Community (EC)—negotiations started late in 1990 and the association treaty was signed in 1991.⁶

As early as 1990, it was decided that the following free elections would take place in 1992. In the CR, a coalition of right-center parties promoting the continuation of rapid economic reforms won. It included the ODS and several smaller parties such as the Civic Democratic Alliance (ODA), the Christian and Democratic Union—Czechoslovak People's Party (KDU-ČSL), and the Christian Democratic Party (KDS). Most dissidents and ministers from the first government formed a new party—the Civic Movement—which failed in the elections. The government coalition won 105 seats in the 200-seat parliament (see Table 2.2).

Table 2.2: Results of elections to the Czech National Council in June 1992

	% vote	mandates
Czech Social Democratic Party	6.53	16
Movement for autonomous democracy party for Moravia and Silesia	5.87	14
Left Block Coalition	14.05	35
ODS and KDS coalition	29.73	76
KDU-ČSL	6.28	15
Liberal Social Union	6.52	16
ODA	5.93	14
Coalition for the Republic – Czechoslovak Republican Party	5.98	14
Other	19.11	–

Source: Žaloudek (1996).

The result was a success for proreform groups—postcommunist parties dismissing (or at least diffusing) further reforms won in many other countries in the region between 1992 and 1996. Even the Slovak situation was different because left-oriented parties headed by the Movement for Democratic Slovakia won the elections. Its chairman Vladimír Mečiar showed populist tendencies. Thus, in the two parts of the country, the election was won by powers that, to a certain extent, stood against each other. The opinion differences, however, did not result from a single election, but stemmed from long-term diverging tendencies in both parts of the federation.

The differences involved different perceptions of the previous regime, much less critical in Slovakia than in the Czech part. For the Czechs, socialism meant permanent lagging behind the advanced world, while the Slovak society moved from agriculture to industry during socialism, and thus it was perceived as somewhat modern (Stroehlein et al. 1999). Repressions after 1968 were much weaker in Slovakia, which resulted in a much weaker dissident movement there as well. Other disagreements appeared after 1990 due to dealing with arms industry situated in Slovakia—see BOX 7.

BOX 7 Arms industry

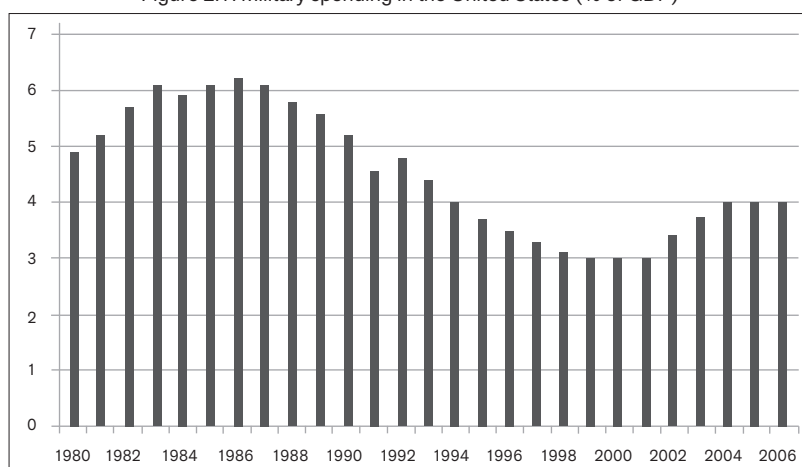
The arms industry was one of the hot political/economical issues that spoiled the relations between the two nations. Slovakia had a bigger share—60 percent compared to 40 percent in the Czech part. Arms were manufactured in over one hundred plants (approximately sixty of which were located in the Czech Republic) and the industry employed approximately 73,000 people directly and some 60,000–80,000 indirectly (Vráblík and Kocevová 1992). The highest

density of arms production was in central Slovakia, where 32.6 percent of the population were employed in the arms industry. The percentage of people employed in the arms industry in some Czech regions was also high—23 percent in Southern Moravia and 17.4 percent in Prague (Hanzlová 1992). Czechoslovak military production in the postwar period reached its peak of 29 billion CSK in 1987. Its share in the total industrial production was almost 3 percent (2 percent in the Czech Republic and 6 percent in Slovakia) and 10–11 percent in the machinery industry (6 percent in the Czech Republic and 24 percent in Slovakia [Ivánek 2002]).

In the 1980s, approximately 70 percent of military production was exported, 60 percent to the Warsaw Pact countries,⁷ the rest to third world countries (frequently insolvent, which is why such claims often remained irrecoverable). Among the main partners were the Soviet Union, Libya, Iraq, and Iran (Kaiser 1995). In this era, the CSSR was ranked seventh in worldwide arms exports (Vráblík and Kocevová 1992), the second biggest producer in the Eastern Bloc after the Soviet Union (Kaiser 1995). Fawn even claims that in per capita exports, the country was ranked first (Fawn 2000).

Ivánek also says that Czechoslovak armories were renowned for their high technical quality and fairly far-reaching diversification into military and civilian production—only in one third of these companies did the share of military production exceed 20 percent, while in general, it usually did not exceed 10 percent (Ivánek 2002).

Figure 2.1: Military spending in the United States (% of GDP)



Source: Economic Report of the President (2007).

The demand for Czechoslovak arms has been dropping since the second half of the 1980s, hand in hand with the relaxation of international tension (for worldwide military technology demand slump see Figure 2.1).

Military production reacted to the decreasing demand since 1988 and in September 1989, the government passed a resolution on the dampening of tank production. After the 1989 revolution, to the federal government furthered limit arms production—compared to 1987, it was supposed to drop by 85–89 percent—80 percent in the Czech Republic and over 90 percent in Slovakia (Ivánek 2002). The damping tempo in Slovakia was later slackened. The conversion of military productions to civilian had to struggle both with its huge scope and the pace of changes despite the state's financial support (Vráblík and Kocevová 1992). Table 2.3 shows the extent of military production reduction.

Table 2.3: Military production in CSFR, 1987–1992 (in 1988 prices)

		1987	1988	1989	1990	1991	1992*
CSFR	billions of CZK	29.3	26.7	19.0	15.1	5.0	3.7
	Index	100	91.1	64.8	51.5	17.1	12.6
CZ	billions of CZK	11.6	12.3	10.6	7.5	2.9	2.3
	Index	100	106.0	91.4	64.6	25.0	19.8
SK	billions of CZK	17.7	14.4	8.4	7.6	2.1 (3.5)**	1.4 (2.3)**
	Index	100	81.4	47.5	42.9	11.9 (19.8)**	7.9 (13.0)**

*—expectation; **—correction after 1990

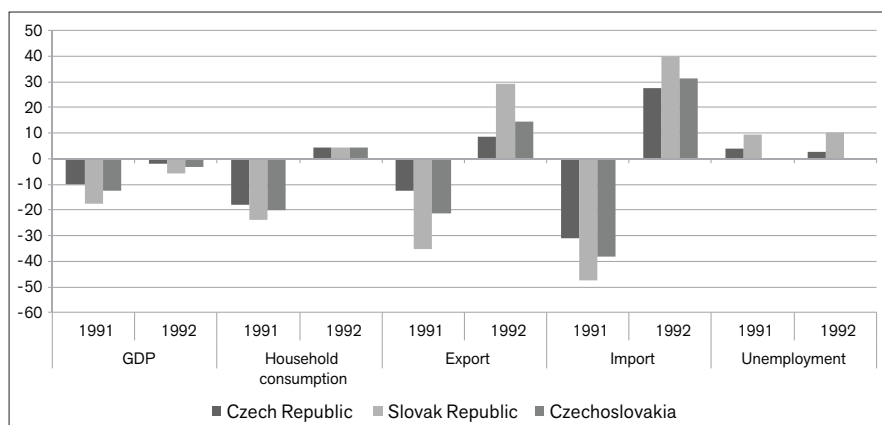
Source: Ivánek (2002).

The political aspect of the military production damping process (for more on specific cases, see Ivánek 2002) was closely observed, especially in Slovakia. It was often quoted in relation to the appeals of President Havel for a moral government. The entire conversion was partly perceived as a political act. As seen above, the damping affected Slovakia more, especially specific regions. Moreover, the Czech prime minister Klaus later permitted arms production in the Czech Republic to resume and Havel agreed (Stroehlein et al. 1999). For Slovaks, arms production thus became a symbol of a soi-disant moral, while in fact hypocritical orders coming from Prague hurt Slovakia. Yet, even in the Czech Republic, the volume of military production and export dropped to approximately one tenth in mid-1990s compared to 1987 (Ivánek 2002).

Another disputed issue was the position of Slovakia in the common state. There is no doubt that Slovaks had (generally) different notions concerning the role of federal and national authorities than Czechs.⁸ National sentiments were much more apparent in Slovakia than in the Czech Republic.⁹ Historically speaking, this is no surprise. Slovaks never liked being told what to do from Prague and strived for stronger independence and self-governance. Certain political dependence was moreover supported by economic dependence due to fiscal transfers directed to Slovakia with the aim to equalize economic differences between the two parts of the country (e.g., Hoen, 1998; Křovák and Zamrazilová 1990).

The different transformation progress also left its negative mark on mutual relations, as it had much more serious consequences in Slovakia.¹⁰ In 1991, the unemployment rate in the Czech Republic was 4.1 percent, but 12 percent in Slovakia. It is therefore not surprising that voices calling for slower reforms in Slovakia appeared.¹¹ Slovak politicians promised slower privatization, less restrictive economic policy, and the end of voucher privatization.¹² The basic economic indicators are presented in Figure 2.2.

Figure 2.2: Basic economic indicators in Czechoslovakia, the Czech Republic, and the Slovak Republic in 1991 and 1992 (in %, previous year = 100)



Source: ČSÚ (2012).

The popularity of certain politicians also played a partial role. Although Alexander Dubček was very popular in Slovakia, his ratings in the Czech Republic were much lower.¹³ The opposite is true for Václav Klaus, very

popular in the Czech Republic but extremely unpopular in Slovakia for his radical reform. Václav Havel faced similar attitudes.

The 1992 election resulted in differences and disputes and in two strong national governments, while the federal government was weakened—with only ten members, including the prime minister. Jan Stráský was appointed the PM. The president resigned in protest at the division of the federation, and the country had no formal head of state for six months.¹⁴ It was clear the situation was heading toward the breakup of the state, which occurred on January 1, 1993. Disputes concerning the specific cause of the division of federation are still raging. Stroehlein and colleagues believe the main cause was the inability of Klaus and Mečiar to find common ground in economic and constitutional matters (Stroehlein et al. 1999). Klaus believes that the division was representative of the Slovak efforts to become independent (Klaus 1994). The breakup was peaceful and it even became, and when compared to the Balkans, a source of certain international appreciation. Nevertheless, this “velvet” breakup did happen against the will of the population. According to 1991 polls, only 9 percent of Czech citizens and 15 percent of Slovaks wanted two independent states (Stroehlein et al. 1999; see also BOX 8).

BOX 8 Economic context of the Czechoslovakia breakup¹⁵

Federal property had to be divided together with the state, either based on territory or population (Mervart 1995). The latter was used when the former could not be applied. The latter criterion was usually implemented in a 2:1 ratio. According to a November 1992 law, assets became property and most of the federal property was divided using the 2:1 ratio. This division related to practically all areas, from military equipment to national debt. Vencovský claims that the ratio was also used for the division of federal budget claims and foreign exchange reserves (Vencovský 2003). The only exception consisted in IMF (International Monetary Fund) assets and liabilities, which were at the Fund's suggestion divided using a 2.29:1 ratio. Credits and deposits of commercial banks were divided according to their places of residence.

Although the basic principle was simple, disputes existed and the ensuing economic relations were burdened with property arguments involving, among others, Czechoslovak Airlines and several government buildings in Prague (Fawn 2000).¹⁶ The principal disputes concerned the property of the Czechoslovak State Bank (SBČS). Due to the division of the former SBČS balance and the division of the federal currency, a debt for the Slovak National Bank

(approved by auditors) totaled 26 billion CZK (CNB 2003). Slovak gold was temporarily frozen for security matters. Despite several international audits, the claim was challenged by the Slovaks and it was not acknowledged. The dispute was solved in 1999. *HN 2000 Yearbook* states that on November 24, 1999, Czech PM Miloš Zeman and Slovak PM Mikuláš Dzurinda signed an international treaty in Bratislava, closing a seven-year long dispute concerning approximately 5 percent of hitherto undivided property inherited from the former federation. They also signed a protocol regarding the handover and takeover of gold from the reserves of SBČS. According to available information, the Czech Republic were to return 4.5 tons of gold withheld by the Czech National Bank (CNB) as security for the multimillion claims. Slovakia did not acknowledge the claim and would pay only a symbolic amount of 1 crown. The CNB noted that by accepting this agreement, the central bank contributed (regardless of the substantial loss) to political consolidation of relations between the federation successors (CNB 2003).¹⁷

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The position of the Czech government, headed by Václav Klaus, remained strong until 1996. Support for economic reforms also remained solid, while the opposition was relatively weak—the first trade union protests since the fall of communism did not take place before March 1994.¹⁸ Heading toward the European structures continued and the government filed the former application to the EU in January 1996.

Table 2.4: Results of elections to the Czech Parliament in June 1996

	votes	% vote	mandates
ODS (Civic Democrats)	1,794,560	29.62	68
Czech Social Democratic Party (CSSD)	1,602,250	26.44	61
KSČM (Communists)	626,136	10.33	22
KDU-ČSL (Christian democrats)	489,349	8.08	18
Coalition for the Republic Czechoslovak Republican Party	485,072	8.01	18
ODA (Civic Democratic Alliance)	385,369	6.36	13

Source: Žaloudek (1996).

Another election took place in 1996 (see Table 2.4 for results). The campaign was quite emotional. The PM's promise of doubled wages by 2000 garnered a lot of publicity. The ODS and the right-wing coalition won again, but the

government lost the majority. The coalition remained the same, but the government was supported by only 99 deputies out of 200. This weakness limited the government's options to continue the implementation of reforms, which was later criticized (see BOX 26). According to some scholars this was the main cause of the subsequent economic difficulties (Klaus 2000).

Disputes within the coalition were gaining momentum in 1996. One of the main issues was the suspicion of machinations in the financing of government parties—especially of the ODS. The quarrels intensified after currency turbulences in the spring of 1997. Calls for government resignation were coming even from the cabinet itself. Eventually, the situation was saved by personnel replacements, with the proreform ministers Ivan Kočárník and Vladimír Dlouhý leaving the cabinet. Illustrative of within the coalition Kočárník's resignation was Josef Lux's (chairman of the coalition member Christian Democrats) condition to stay in the government (Kočárník 2000). On July 10, the parliament took the confidence vote and the government survived by a single vote—that of former social democrat Josef Wagner. Nevertheless, the fragile cabinet only lasted until the fall. At this time, the economic crisis was apparent and disputes within the ODS escalated. Eventually, the wing criticizing Klaus severed and later formed a new party—the Freedom Union (Unie svobody [US]). As a result, the government of Václav Klaus fell. An early elections were called for 1998 but in the meantime the country was led by a caretaker government headed by the former Czech National Bank governor Josef Tošovský. Regardless of these problems, the Czech Republic was invited to join the NATO in December 1997. The early elections in 1998 were won by Social democrats (ČSSD). The ODS joined the opposition.¹⁹ However, it had spent the longest time in power of all transforming countries' cabinets (Dillon and Wykoff 2002; see also Table 2.5).

Table 2.5: Results of elections
to the Czech Parliament in June 1998

	Mandates
KDU-ČSL	20
ODS	63
ČSSD	74
KSČM	24
US	19

Source: Ročenka HN 1999 (1999).

The ČSSD chairman Miloš Zeman—was unable to form a majority government and this led to the so-called opposition treaty with the ODS. This treaty (massively criticized by all sides, including civil groups) made it possible for the minority government to remain in power throughout the entire electoral period—that is until the 2002 elections. Its position in some periods was weak, though.²⁰ One of the key issues in the political program of the Social democrats was the campaign called “clean hands.” The government thus tried to punish economic crimes of the previous era. But the results of the campaign were negligible.

In December 1997, the European Council Meeting in Luxembourg decided to start negotiations on the Czech accession to the EU. The negotiations began in March of the following year (Piskorzová 2003). The Union created a system of accession criteria—the so-called Copenhagen criteria. The Czech Republic was required to become a fully functioning democracy with a full-fledged market economy. It was also necessary to harmonize Czech law with the EU legislation. This harmonization was carried out throughout the subsequent period until the accession. The country also joined the NATO during the reign of the social democratic government in 1999. The next scheduled elections took place in 2002; ČSSD won again and created a fragile coalition government (101 to 99) with the KDU-ČSL and the US (see Table 2.6).

Table 2.6: Results of elections to the Czech Parliament in June 2002

	% vote	mandates
ČSSD	30.20	70
ODS	24.47	58
KSČM	18.51	41
Coalition (KDU-ČSL; US and DU)	14.27	31

Source: Žaloudek (2004).

Václav Havel was the president since the establishment of the independent Czech Republic until 2002. He was replaced by Václav Klaus in 2003. That year it was decided that the country would join the EU in May 2004. Seventy-seven percent voted for the accession in a referendum (ČSÚ 2003).

2.1 Overall evaluation of the political development

Political development was the key factor in the course of its transformation. The Czech Republic was democratic for the whole period and it meant that the politicians needed to gain political support for the economic reforms. It was generally difficult to proceed with reforms if the political situation was fragile. Therefore, keeping political support for their reform steps was of utmost importance. The Czech politicians were fully aware of the role that political support played in the reforms. Klaus writes, “During transformation, all you need to do is avoid making mistakes and acquire political support for the measures you plan to take. As an economist I consider the political side of the matter to be of utmost priority, requiring maximum attention. System transformation is not divisible to its economic and non-economic aspects” (Klaus 1995b).

The politicians faced a dilemma during the transformation period. They could proceed with the transformation steps that were often politically unpopular and that would decrease their chances to be reelected. Or try to avoid these problematic measures and increase their chances to keep in power. The dilemma worsened during the time when the political support for unpopular measures evaporated (see the theory of political capital in the next chapter) and it was at its worst in a situation of unstable coalition government when the political support for the government was fragmented and interests of the voters as well as of the political parties diverged. The final political decisions were a kind of compromise between these two pressures.

From the standpoint of political development, I may divide the entire period into two parts. In the first period, lasting from the beginning of the decade until 1997, reforms carried out by the right-center governments enjoyed more or less widespread popular support. However, this support was gradually dwindling and the government after 1996 elections was much weaker than the previous one, while its efforts (and options) to continue the reforms were substantially weakened. It is a matter of dispute whether this political development and the “longevity” of the cabinet led by Václav Klaus helped the transformation progress. Orenstein, for example, claims that the government’s longevity led to quick privatization but did not prevent corruption and led to fixation of certain economic problems (Orenstein 2001). Similarly, Belka—drawing on the Polish experience—believes that the government change during transformation may hasten the entire process

(Belka 2001). The political responsibility for this process in the Czech Republic lies nearly entirely with the right-wing parties.

During the second period, Social Democrats—harsh critics of the right-center governments—were in power (alone or in coalition), but the reality forced them to continue the reforms. The governments led by Miloš Zeman, enforced consistent privatization of the banking sector and took decisive steps to sell state-owned companies. The reform efforts did not collapse and there was no return before 1989 and the social democratic government did not show any tendency to return back to central planning as some analysts had feared. Yet some expectations were fully met, especially about the government's willingness to keep control of the fiscal balance. It is also apparent that both of these social democratic governments were politically weak—one had only minority, the other had the slightest majority in the parliament. Their chances of pushing their own policies through were thus markedly limited. To sum it up, the Czech electoral system led to highly fragile political situation.

The principal success of political development in the Czech Republic is the fact that political rights were fully respected.²¹ The country was assessed as politically free and stable by independent foreign observers, such as the Freedom House²² (see Table 2.7 for results). The organization currently uses two indexes—one relates to political rights and assesses the citizens' chances to participate in the political process. The other index relates to civic liberties; in other words, it evaluates the institutions' freedoms, opportunities to express one's own opinions, personal autonomy, and so on.

Table 2.7: Political rights, civic liberties, and the status of the Czech Republic as evaluated by the Freedom House, 1993–2003

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Country statute	Free	Free	Free	Free	Free	Free	Free	Free	Free	Free
Political rights	1	1	1	1	1	1	1	1	1	1
Civic liberties	2	2	2	2	2	2	2	2	2	2

Political rights: 1—nearly perfect; 7—no political rights; civic liberties: 1—nearly perfect, 2—states with this grade have drawbacks in three to four areas, but are relatively free; 7—civic liberties practically do not exist.

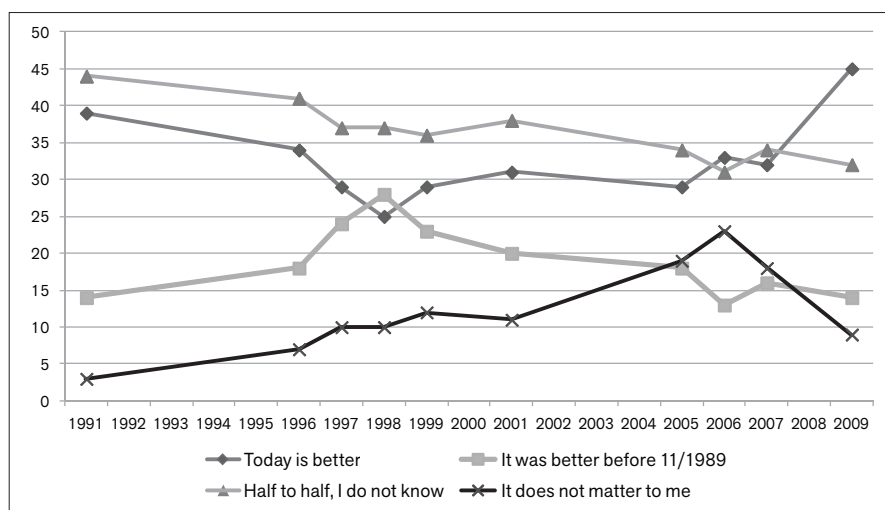
Source: Freedom House (2003).

Index one gives evidence that respect to political rights in the Czech Republic is nearly perfect. The evaluation of civic liberties is a little worse—grade 2

ranks it among countries with three to four deficiencies. Specifically, the country is reproached for some partial misdemeanors and the position of the Roman (Gipsy) minority. But overall, the Czech Republic is evaluated as a free country.

It is important that popular support for the new democratic system remains high—only a small minority wants the previous regime back, and especially the percentage of young people with such leanings is very small. Development of the attitude toward the past and the contemporary regimes can be seen in Figure 2.3.

Figure 2.3: Attitudes toward the past and contemporary regimes



Source: CVVM (2011).

Table 2.8: Approval of nondemocratic alternatives in 2001
(% of people who consider it to be a better option)

	Communist	Military	Dictator		Communist	Military	Dictator
Slovakia	30	3	25	Hungary	17	2	17
Bulgaria	27	132 [sic]	28	Lithuania	14	5	40
Slovenia	23	6	27	Estonia	8	2	40
Poland	23	6	33	Latvia	7	4	38
CR	18	1	13	(average)	(18)	(6)	(29)
Romania	19	14	32	Russia	47	15	31

Source: Rose (2003).

Support for military dictatorship was also negligible in the Czech Republic (see Table 2.8) especially in comparison with some of the countries of the Eastern Bloc.²³

I can conclude that democracy was stable and popular during the entire period in the Czech Republic. But it does not mean that there were strong governments. I can generally divide the period into two. There was a relatively strong support for the reforms during the first period that lasted until 1997. Since that time or possibly even since the election in 1996 the governments were weak and in most of the cases it was even difficult to establish them. As a consequence, governments often postponed difficult and demanding tasks.

Notes

- ¹ Doyle and Walsh argue that people were generally able to estimate their prospect in the new regime and according to it voted for the Communist Party or the reform movement in the first elections (Doyle and Walsh 2007).
- ² The first economic program of the Civic Forum reflected contemporary situation in the movement; according to Myant, it was vague (Myant 2003). Valtr Komárek was appointed in charge of its implementation. The program assumed structural changes, but it contained no practical guidelines. Komárek refused the Polish shock plan and he strived for a “specifically Czech approach” lasting several years, avoiding high inflation and mass unemployment. However, already in April 1990, Komárek lost the trust of his colleagues and was replaced by former dissident Václav Vališ.
- ³ With this step, Klaus sought to change the all-embracing antitotalitarian movement into a standard political party with transparent structure (Novák 1993).
- ⁴ Before March 1990, the official name was the Czechoslovak Socialist Republic. It was later changed to the Czech and Slovak Federative Republic (CSFR) and it remained so until the end of 1992 (Žaloudek 2004). However, disputes continued and some Slovak deputies kept fighting for a hyphenated title that the Czechs refused because of historical reasons.
- ⁵ Slovak House of the People did not initially vote for Havel.
- ⁶ This treaty did not come into force because of the breakup of the state. The Czech Republic was associated with the Union after the approval of the Association Treaty in October 1993 and its coming into force on February 1, 1995 (Piskorzová 2003).
- ⁷ Warsaw Pact (1955–1991) is the informal name for the Warsaw Treaty Organization of Friendship, Cooperation, and Mutual Assistance. It was a military organization of the communist states.
- ⁸ For details on competence disputes, see Frydman, Rapaczynski, and Earle (1993).
- ⁹ Even the usually moderate Slovak Christian Democrats wanted their own “chair and star” after the entry into the EU.
- ¹⁰ For reasons of worse economic results in Slovakia during transformation, see Komínková (1993).
- ¹¹ Novák writes about different attitudes of Czech and Slovak citizens toward the reform as shown in polls since 1990. He claims that Czechs perceived the reform implementation as the main task, while Slovaks emphasized the social consequences of the reforms.
- ¹² According to the February 1992 polls, most citizens of Slovak and Czech Republics wanted to preserve the federation. However, the same poll showed that only 17 percent of Slovaks approved of the reforms, compared to 37 percent of Czechs;

64 percent of Slovaks wanted a gradualist reform, while 52 percent of Czechs wanted a radical reform (Dillon and Wykoff 2002).

- ¹³ As a compromise, the former secretary general was named the chairman of the Federal Parliament.
- ¹⁴ When the breakup of the country was irreversible, Havel returned to the presidential seat in the Czech Republic.
- ¹⁵ I also deal with the division of the state in case studies about customs union (see BOX 40) and common currency (see BOX 20).
- ¹⁶ The dispute also concerned 7.5 tons of gold dating back to the World War II fascist Slovak State, while the Slovaks, in this specific case, presented arguments based on the origin of this property (Mervart 1995). In the tense atmosphere, Klaus even proposed that Slovaks might not receive shares from the first wave of voucher privatization (Husák 1997).
- ¹⁷ Another partial dispute involved the lawsuit between the ČSOB and the Slovak state, won by the former in the winter of 2005.
- ¹⁸ The demonstration was against the alleged government's effort to pass on the burden of reforms to the employees.
- ¹⁹ Right-center parties had majority in the parliament, but their leaders were unable to negotiate a viable agreement.
- ²⁰ Agreements between the ČSSD and the ODS included commitment to modify the constitution and the electoral system toward majority. These changes were eventually prevented by the Constitutional Court.
- ²¹ The influence of extremist parties, which endeavor to replace democracy with a different system, was relatively small, although I expect strong antidemocracy moods in the period of economic turbulences.
- ²² The Freedom House is a nonprofit, apolitical organization founded by Eleanor Roosevelt.
- ²³ For more on the political situation and risks in transitive economies, see Žák (2005).

TRANSFORMATION PROCESS IN GENERAL

This chapter focuses on the general direction of the transformation process. It clarifies the differences between transformation and reform as well as transformation goals and various approaches to the entire process. I will stress foremost the differences between a shock therapy and a gradual approach. The chapter gives a global view on the transformation process, or to be more specific, on ways transformation could pursue. The chapter is thus distinguished from the following chapter that concentrates on the actual transformation steps.

It is important to understand a clear distinction between transformation and reform. The former term is used to characterize changes in the entire system of economic (or even social) functioning—in our case to illustrate the system change from centrally planned to market. The latter term represents a partial change in system elements—for example, a tax reform (be it a market or centrally planned system) or a pension system reform—while the system as a whole remains unchanged (see Slaný 2003).¹ However, Klaus writes about economic measures in 1991 as if it were a reform, while he understands transformation in a broader sense:

Our (Czechoslovak) 1991 economic reform meant system liberalization, price and foreign trade deregulation, internal convertibility and, as a revolutionary aspect of transformation, it is more or less finished. Transformation in a broader sense—especially its evolutionary aspects—still continues. Structural changes are in progress, institutional framework is taking root, the government may intervene in one way or another and “nudge” the development in a certain direction, but this is not a revolutionary leap anymore. Transformation is a spontaneous evolutionary process with millions of participants. I am just one of them. (Klaus 2000a)

Overall, transformation is an incredibly complicated process in which the very way of thinking about market subjects must be changed. It is an immense task in which all of the subjects must accommodate to radically new conditions.

The question concerning the goals of transformation is obvious: What is the final state to be achieved? There is no unequivocal answer to this question. Even the reformers themselves would probably not agree on the exact character of the target system. Failures of the previous system were apparent to almost everyone. There was a general agreement concerning the effort to push the Czechoslovak economy in the direction of an advanced market economy. This is why it is difficult to identify the desired condition, as there are many different market economies in the world, varying in social policies and levels of state intervention. These differences were apparent in various opinions regarding the desired state of affairs. In several stages of transformation, disputes concerning the goals—whether the society strives for a market economy without attributes, a socially oriented market economy, or some form of the so-called third way (see BOX 9) were getting rather fierce.² These varying opinions were also mirrored in disagreements about the character of transformation, namely regarding the tempo of changes and the state's role in the entire process.

BOX 9 The dispute concerning desired forms of transformation

Defining individual general variants of transformation is not easy. Kotoučková (2001) considers three main opinion groups:

- the “third way”—improvement of the current system—strengthen the role of the market in the planned economy, create competition between companies, suppress monopolization and cancel subsidies to ineffective companies. This alternative was promoted, for example, by Pick.
- socially oriented market economy—its advocates preached Keynesianism and proposed state interventions—a mixed economy with a strong state. Their priority was full employment. This method was promoted by Zeman, Komárek, Klacek, and Matějka.
- liberal economy, which advocates a small state, minimum state interventions, and low inflation. This approach was supported by Klaus, Dyba, Zieleniec, Ježek, and Dlouhý.

At least rhetorically, the third (liberal) approach prevailed in the governments (see BOX 10). Its advocates, and especially Klaus, defended the liberal goal of transformation against the efforts to shift it somewhere else. Take the following quotation as an example:

We need a natural, non-restrictive, full-blooded, unspoiled market economy and we need it now. Instead of waiting and prolonging the agony of post-totalitarian, post-centrally planned society and economy, instead of looking for partial, temporary, incremental targets or sub-targets, we must find a straight path, an ideological highway that will give us an optimal fast route to the final goal (the so-called highway theorem). On this highway, there is no room for socialism with a human face promoted by the Prague Spring of 1968, for flirting with the dreams of "market socialism," so adored by western Social democrats and labourists, or for perestroika concepts currently prevalent in the USSR. (Klaus 1992)

Advocates of a social market economy were to be found among the Christian democrats (KDU-ČSL). However, Klaus was a strong opponent of this concept and of using the term at all:

If I refuse such terms as "social market" or "social environmental market" economy, it is not because I refuse social policy or social solidarity as a principle, but because these terms have been used by the opposition to advocate and promote something that has very little in common with the market economy or effective social policy. (Klaus, 1994)

Tříška remarks that in his view it was impossible to use the term capitalism in a decent company. There were also disputes about the so-called third way, which was seriously proposed in the very beginning (Tříška 2009; see also Kotoučková 2001; Mičoch 2000). The problem lies in the very definition of what the third way means in practice. Even scholars who favor this approach are rather vague about its real goals, Pick understands the third way as a balanced role between state and market, while he considers the Czechoslovak reform attempts in the 1960s to be a successful example thereof (Pick 2000). Šíma also warns that the entire concept is only vaguely defined. He mentions that the third way advocates admit that the direction is only loosely anchored and that the "third way concept may assume various forms in various countries" (Šíma 1998). Šíma critically notes that the third way advocates want an absurdly

paternalistic and in substance an antisocial alternative of problem solving, masked by sweet words of equality, mutual solidarity, and the so-called social responsibility. He claims the third way theory is a successor to the theory of convergence of capitalism and socialism, developed in the USSR in the 1960s and 1970s. It is based on the assumption that the better features of both systems will be merged.

Václav Klaus's statement about "the third way leading to the third world" is well-known (see Fawn 2000). According to Klaus:

They always take several undoubtedly positive particulars and create a blend that looks nice at first sight, but the components are mutually exclusive. They always search for a society that is free and fair at the same time, a society that is efficient and effective while being paternalistic (and not punishing inefficiency), they always look for something that is not a society of "atomized" individuals, yet not a bureaucratic state either. (Klaus 1995a)

Just how unclear the term is may also be illustrated by the opinions of Allen and Haase (2001). They define the third way as the social democratic approach—a combination of market and state interventions to achieve the goals of socialism in the form of a just and prosperous society.

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Generally speaking, there was a majority agreement among the economists and politicians concerning the economy heading toward the market system. Fawn writes that, despite varying opinions, everyone wanted the market (Fawn 2000). Myant is more cautious to claim that all those participating in the discussion at least "looked like" they wanted "a modern market economy" (Myant 2003). Klaus goes on to say: "our aim from the very start was to create a standard market economy, based primarily on private ownership and the creative initiative of free citizens" (Klaus 1994).

What specifically had to be changed during transformation from the centrally planned system to the market system? The necessary changes can be classified from a time perspective. It was possible to implement some reforms almost immediately—price liberalization; foreign trade liberalization; opportunity to establish new companies; remove subsidies; establishment of capital and financial markets; legislative emancipation of all forms of ownership. In addition, the reformers faced long-term tasks necessary for the

creation of a functioning market system. These included building an entire legal system, changing the judicial system (i.e., make the law enforceable), and transforming informal institutions (e.g., the moral climate). It is obvious that the long-term tasks were the most complex and the most important for the transformation goals' achievement.

Opinion differences concerning the intended state were reflected in the approaches to the entire transformation process. The pace of the process was the crucial dividing point, from which two opinion platforms were formed—gradualism and shock therapy.³ As the terms suggest, supporters of the former approach strove for a slower pace of reforms, while supporters of the latter wanted to carry out reforms as quickly as possible. This classification is, however, partly artificial as there was no clear division between the two groups, but rather a wide spectrum of varying opinions. Orenstein believes the division does not reflect the practice,⁴ while Klaus claims explicitly that the speculations about gradualism and shock therapy are futile and overly politicized (see Klaus 2004; Orenstein 2001).⁵

The advocates of shock therapy anticipated quick implementation of basic reforms, accompanied by stabilization measures of economic policy, while the state gradually diminishes its role in the economy. It should be mentioned that it was impossible to implement the institutional reforms quickly. Advocates of quick reforms were motivated by numerous political and economic factors and, last but not least, the popular climate. The reformers believed that people were willing to make sacrifices in the initial stages of transformation, but that this willingness would soon be exhausted. It was probably Balcerowicz who expressed this notion most aptly in his theory of political capital.⁶ According to this theory, political capital originates in times of positive political changes. However, it must be used in a short period of time—while the society is still enthusiastic about the change, the consensus is almost universal, and people still trust politicians—because this political capital evaporates quickly (see Orenstein 1991; Slaný 2003). Reformers also thought that if they advanced slowly, transformation would be threatened by the “loss of momentum”. Such slow advance would be accompanied by consolidation of interest groups (such as trade unions or bureaucracy), which put up little resistance at the beginning of the reform process. Shock therapy was also considered to be part of the process of coping with the past and the guarantee that the entire system change was irreversible (see Holman 2000).

Klaus says:

The nature of our reforms must be articulated clearly and they must be quick and adamant! Openness, speaking the truth about unpleasant things and playing with open cards is the best strategy. Any delay may prove to be fatal. Delays give opportunities to those who lose something due to the changes to get together and obstruct further development, to defend their privileges once again. (Klaus 1991)

Krkoška discusses the effort of reformers to change the role of the state in the economy. The endeavor to establish the market system stems from this goal (Krkoška 1999). Other arguments against delaying of reforms are quoted by Slaný (2003). Reformers were afraid that hesitation might be interpreted in the West as a lack of resolve or a third way effort, and that the institutions of that time (such as central planning) were unable to react to the changing situation appropriately. Conversely, Klaus writes: “it was clear to us that the economic transformation is a long term process and cannot be implemented ‘overnight,’ and that it will require an active participation from all of us” (Klaus 1994).

Clearly, transformation combined with restrictive economic policy had to be accompanied by certain economic expenses. Advocates of gradualist transformation claimed that the expenses—decline in output and growing prices—for the entire process can be minimized if its individual measures are taken slower. They especially promoted slower liberalization of foreign trade and prices, and gradual privatization. However, gradualism was not clearly defined, nor was there any consistent theory of gradualism (see Kožušník 1997; Krkoška 1999). Gradualists were also generally more optimistic about the situation of the companies (see Kiss 1993). They also believed the state should play a key role in the entire transformation process, especially through active industrial policy (for more on this, see BOX 55). The gradualist approach would have resulted in slower emergence of markets (Sojka 2000). Another argument was used by Krkoška who says that the gradualists were afraid of violating social consensus that might have occurred with quick and massive bankruptcy of a larger portion of the economy due to the shock therapy (Krkoška 1999). Alternatively, advocates of quick reform did not believe the state (bureaucracy) would be able to steer these slow changes. Another gradualist argument was that the slower approach would provide enough time to prepare for the entire process properly (Holub 1996). Jonáš warns of the

transformation trap risk, when slow progress of reforms only makes the situation worse—the central plan is dismantled, but full market is not implemented yet (Jonáš 1997). The economy would thus end up in a vacuum with no plan and no market. Gradualist practice is also highly questionable.

The dispute concerning the gradualist versus the shock approach on reforms is not over yet. Proponents of the former present the success of China as an example of reforms achieving better results when carried out slowly (McMillan 2004; Stiglitz 1998). Yet others point out the success of shock reforms in central Europe and use statistics to prove that these reforms were more successful (Gros and Steinherr 2004; Havrylyshyn 2004). Still other advocate the gradual pace of the reforms, believing that Poland would have been able to reach better economic outcomes if it had followed gradual recommendations (e.g., Kolodko 2005).

An entirely different approach to transformation, which considers the progress of reforms, is mentioned by Holman, who categorizes possible approaches into liberal and institutional (Holman 2000). Liberal strategy prioritizes the creation of market impulses by implementing basic system changes, such as the liberalization of markets and privatization. These market impulses then contribute to the origination of market institutions. The other—institutional—approach assumes that institutions (both formal and informal) are created first and markets are created later. Because the creation of institutions is a complex process, quick advancement of reforms in this case is in fact undesirable. Holman believes that both approaches have negative aspects. On the one hand, if the market is created without stabilized rules and institutions, as the liberal approach assumes, it is very likely that the subjects will behave in undesirable (amoral) ways. On the other hand, hesitation with creation of markets and market impulses leads to stagnation and slowing down the entire process. Holman claims that both approaches are mutually incompatible, that there is no optimum strategy, and it is necessary to choose one of the two options.

3.1 Transformation strategy

The first concise project of transition to market economy was put together by the National Economic Council headed by František Vlasák and was titled “The Strategy Proposal for the Transition to a Market Economy in March

1990.” It proposed a relatively slow tempo of transformation, standard methods of privatization, and active structural policy. Liberalization of foreign trade was also planned slower because of concerns over the fate of the corporate sector.⁷ The proposal was based on the gradualist conception of economic transformation. Among its foremost proponents were Valtr Komárek, Karel Kouba, Lubomír Mlčoch, and Zdislav Šulc—economists, some of which were linked to the late 1960s reform movement.

Another project—“Strategy of Economic Reform,” prepared by the federal Ministry of Finance and masterminded by Václav Klaus—was submitted in April 1990. It emphasizes the quick pace of reforms, price liberalization (including internal currency convertibility), foreign trade liberalization, massive “denationalization,” and currency devaluation. The reform team included, among others, Vladimír Dlouhý, Tomáš Ježek, Ivan Kočárník, Dušan Tríska, Josef Zieleniec, and Jan Stráský.⁸

In September 1990, the official transformation program, “The scenario of economic reform,” was approved (*Hospodářské noviny* [HN], September 4, 1990). The program combined elements of both plans, but most suggestions were taken from the federal proposal.⁹ As time went on, economic practice leaned even more toward the federal proposal (Sojka 2000). The scenario was similar to the Polish plan of shock therapy, but it also involved quick privatization, including a mention of voucher privatization. By contrast, reforms simultaneously implemented in Hungary were usually perceived as gradualist (see Lavigne 1999; Srholec 2001).

The reform was thus, at least in its first stage, just like a shock therapy, although some consider the start slow in comparison to Poland that started its reform already at the beginning of 1990 (see, e.g., Fawn 2000). The author was probably not aware of the different political development in the two countries.

BOX 10 Economic policy trends

Earlier, I suggested that, in general terms, we may categorize the target status proposals into three categories—liberal, social market, and third way. The third option was discarded and Klaus, as the main proponent of reforming efforts, bitterly opposed anyone considering any option other than the standard market economy. Yet even the standard market economy assumes different forms in various countries. What was the reality of the transformation process in Czechoslovakia, and later in the Czech Republic?

The transformation was certainly not as liberal as its authors publicly claimed. Sojka observes that the best description of the government policy would be "right-wing rhetoric with left-wing practice" (Sojka 2000). He also writes that although the theory was liberal, many decisions were purely pragmatic due to the pressure of reality. In reality, he says, there was no shock therapy, but rather state corporatism, social market economy, and adhoc crisis management all combined. Hoen also believes that Czech economic policy did not correspond to its liberal rhetoric (Hoen 1998). Orenstein notes that the government program was radical macro-economically, but social democratic in terms of the labor market and welfare state (Orenstein 2001). He also says that Czechs had a neoliberal program, accompanied by social measures aimed at the preservation of political support. He labels the Czech approach as "social-liberal." He believes these approaches made it possible for Klaus's neoliberal governments to remain in power longer, but made it impossible to rectify the mistakes these governments made. Fawn also writes about the efforts to preserve the social consensus (Fawn 2000). Holman mentions that the politicians could not find support for cutting down welfare (Holman 2000). Krkoška maintains that shock therapy was implemented because of the victory of right-wing parties, but it involved elements of gradualism, from tolerance to unprofitable enterprises (Krkoška 1999).

In other words, all the scholars agree that the reforms were liberal only to a certain extent. Chavanec agrees with them and adds that despite the antimixed economy rhetoric, some kind of mixed economy was being created in reality (Chavanec 1993). Klaus rejected those who criticized the government for withdrawing from the reform program and for carrying out policies that were too socially moderate. In another place, he states directly that he considered the government policy to be fully consistent, but he does not address individual objections in the text (Klaus 1994).

The criticism changed its tone in the years to come. The critics started to argue that the reform efforts were too weak and the reform process is not finished (see BOX 26).

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Czech reformers were influenced by a wide range of ideological platforms. Classical liberalism played a major role. For example, Klaus often quotes A.F. Hayek (Klaus 1991). Other sources of inspiration included conservative schools of the 1980s, such as monetarism, rational expectations school, and the public choice school. They were also influenced by economic practice of

Thatcherism (Holub 1996)¹⁰ and post-World War II German economic reform (Klaus 1994). There are disputes concerning the role of foreign institutions and advisors. The so-called Washington Consensus is supposed to have played a crucial role. According to many, it is a set of rules for emerging market economies enforced by the IMF, the World Bank, and the US Treasury Department; in other words by the institutions residing in Washington, DC. The rules involved deregulation, price liberalization, liberalization of foreign trade, and institutional change. However, this set of rules was not explicitly defined by these institutions and it has not become an official doctrine (see Dlouhý 1999). Rather, it became a welcome pretext for those who wanted to criticize the reformers (see Pick 2000; Sojka 2000).¹¹ Undoubtedly, reformers sought advice of foreign advisors with concern to exchange rates and forms of privatization (see, e.g., Husák 1997).¹² The American economist Jeffrey Sachs was often mentioned in this context, but he influenced Polish reforms much stronger than those in Czechoslovakia.

Further, reformers had other economic reasons for rapidly implementing reform steps. To understand the decisions taken at that time, we have to consider their main concerns before the transformation strategy was approved. These concerns stemmed from the situation in the early 1990s. It seems that the uncontrolled growth of prices after the price liberalization was perceived as the greatest danger (these fears were not unsubstantiated; e.g., Poland suffered from hyperinflation).¹³ Other fears were related to monopoly structure misuse and the balance of payments breakdown. All three issues were intertwined. As I have already mentioned, corporate structure was nearly monopolist. Reformers were afraid that these enterprises—unless exposed to competition—would abuse their positions and the prices would skyrocket (Jonáš 1997; Klaus 1995a). This was, however, just one inflation factor. Other concerns involved potentially extensive growth that would lead to price increases resulting from the shortage of raw materials (Holman 2000). In general, reformers were afraid that the price growth would result in an inflation wage spiral—the price growth leading to wage increase pressure—which is an inflation factor in itself (Hampl 2001; Holman 2000; Klaus 1995a). Another feared spiral was the inflation devaluation spiral (e.g., Holman 2000; Jonáš 2000). The problem originated in the following way: the liberalization of foreign trade leads to imbalance on the current account of balance of payments, and eventually of the entire balance of payments.¹⁴ This results in pressure on currency devaluation. Devaluation means higher im-

port prices, resulting in higher domestic prices and therefore in inflation. The consequences of devaluation would also spread through other channels. Currency devaluation means lower real wages. Employees would fight for higher nominal wages. Higher wages increase expenses and decrease profits, so enterprises would react by increasing prices of their products. Higher prices result in lower international competitiveness, resulting in pressure on currency devaluation. A clear example of the vicious circle of devaluation—an inflation spiral that the reformers decided to cut by restrictive economic policy before it started.

This mutual intertwining of problems is best mirrored in the issue of monopoly structures. It could not have been expected that the newly created domestic competition would be able to face the monopoly structures on the domestic market immediately. The only chance to increase competition on the domestic market was to open it to foreign competition. Yet the liberalization of foreign trade carried the risk of the devaluation inflation spiral. In light of these considerations, it is not surprising that the reformers opted for the restrictive economic policy.¹⁵

Moreover, the reformers made an effort to anchor the entire economic system in some way. They believed that at least one macroeconomic quantity should remain fixed in the era of general destabilization, and market subjects should use it as an anchor for their decision-making. Eventually they chose fixed exchange rates, but in the initial phases of transformation they also used other stabilization instruments (see BOX 11).

BOX 11 Transformation anchor

One of the reformers' main concerns in the transformation involved uncontrolled price growth. The reformers believed that at least one quantity should remain fixed. They had several options—monetary aggregates, exchange rate, regulation of selected prices (for example energy), or wage control, or a combination of options (Kvizda 2000). Anchors were supposed to be removed gradually, as the market mechanism settled in.

Klaus says that liberalization and deregulation measures at the beginning of the transformation must be as far-reaching as possible—fluctuation of economic quantities must be possible, with one exception—the exchange rate, which must represent the anchor (Klaus 1995a). In another text, he writes: “we based our considerations on the general assumption of the theory of equilibrium—the necessary condition for determination of balanced values of

nominal quantities in the system is to have one of these variables exogenously fixed" (Klaus 1994). Similarly, Holub says that the exchange rate was used as an anchor for the other quantities to be bound to (Holub 1996).

It seems that in the early stage of transformation, several anchors were used simultaneously; for example, the double anchor was used in the form of wage control and exchange rate (Borensztein, Demakas, and Ostry 1995). Moreover, the central bank tried to target the M2 aggregate, which can also be perceived as a system anchor. Still, most economists would agree on the fixed exchange rate as the basic transformation anchor.

Jonáš affirms that such anchoring has numerous advantages—it prevents expansive economic policy, represents a fixed point for market subjects, results in positive inflation anticipations, obligates the central bank to exchange foreign currency for crowns, supports repatriation, and restricts inflation (Jonáš 1997). The result should be a more stable price level and a better economic environment.

Empirical experience should corroborate these assumptions. Jonáš states that the countries that used the fixed exchange rate as the economic anchor achieved better results in decreasing inflation (Jonáš 1998b). Conversely, he admits that this exchange rate regime had been chosen by countries with higher anti-inflation ambitions. Similarly, Klaus wrote: "the key factor for the success of the macroeconomic stabilization procedure consisted in simultaneous devaluation and fixation of exchange rate" (Klaus 1994).

As time went by, downsides of this exchange rate policy began to surface. For example, Frait and Kotlán concluded that sticking to the fixed exchange rate was the main cause of the crisis after 1997 (Frait and Kotlán 2000). Appreciation of the real exchange rate was at the core of the problem (see BOX 23). This criticism was not aimed at the initial application of the fixed exchange rate as an anchor, but rather at the fact that it was kept on the fixed level for too long.

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Changing the legislative system was another key factor in the transformation process—an exceptional task in itself. Practical ignorance of market functioning and the lack of experience of politicians, economists, and lawyers must also be taken into account. No wonder that the legislation in the first stage of transformation was not perfect and the laws contained numerous loopholes. Practical policy involved trial and error methods, and errors in previously passed laws were removed as time went on. Repercussions of this

approach were bothersome for the population and enterprises alike, as everyone had to get accustomed to ever changing legislative conditions.

In a nutshell, reformers pursued restrictive economic policy and aimed to cut off dangerous spirals. Other instruments they used included anchoring (fixing) of the exchange rate. Finally, wage growth was also perceived as a destabilizing factor, so the government tried to keep it within certain limits.

Notes

- ¹ The term “reform” has two meanings—to describe a change in the functioning of the economy regardless of whether the change relates to system-constituting or regulative elements (Šulc 1998). In another sense, it describes only changes in regulatory elements while system-constituting elements are preserved. However, economic transformation is the change of the mechanism of economic functioning, when both system-constituting and regulative elements are transformed simultaneously.
- ² Varying opinions regarding the desired state were held by both the economists and general public. According to a June 1991 poll, 5 percent of respondents would prefer the socialist regime before 1989, 48 percent would prefer market without labels, and 47 percent supported socially oriented market economy (Večerník 1993).
- ³ Kiss presents a deeper classification. He classifies reformers as radicals (shock therapy); Keynesians (who are against strong restriction of aggregate demand); market socialists (who recommend stimulation of market relations based on state ownership); price reformers (who oppose quick price liberalization for fears that current firms will abuse their monopoly positions and they propose preserving price controls until the companies start behaving market-like); institutionalists (who wish to create institutions simultaneously with privatization and marketization of state sector); evolutionists (who claim the economy needs time to adjust to new conditions); and semi-radicals, who combine radical and gradualist elements (Kiss 1993).
- ⁴ Orenstein also believes that this division was invented by radical liberals to confirm the shock therapy (Orenstein 2001).
- ⁵ Elsewhere Klaus writes that gradualism means a dual system where reformed and unreformed sections of economy coexist, for example in China, which is possible only in enormous democratic deficit conditions (Klaus 2001).
- ⁶ Leszek Balcerowicz was the finance minister in the first Polish reform government.
- ⁷ The proposal considered two versions of liberalization (see Slaný 2003).
- ⁸ Additionally, Robert Holman was a long-time adviser to Václav Klaus.
- ⁹ Ježek stated that after the elections in June 1990, the opposition against Klaus’s reform in the Czech government practically disappeared (Ježek cited in Husák 1997).
- ¹⁰ Stroehlein et al. mentions that Klaus considered himself to be Margaret Thatcher’s follower (Stroehlein et al. 1999).
- ¹¹ More on the original and the mission of the Washington Consensus as a set of rules for South American countries—see Williamson (2003)—the author of the original thought.

- ¹² In this context, it is worth quoting Havel, who writes that experience with a normal advanced economy was not entirely relevant for transforming economies and foreign advisors often made more serious mistakes than the domestic pragmatists (Havel 1998).
- ¹³ Price stability was the highest priority for the reformers, and all other macro-economic targets, such as economic growth, employment, or balance of payments were subordinated to it (Sacks 1993).
- ¹⁴ For more on the balance of payments system, see BOX 42.
- ¹⁵ For example, Klaus perceived the spirals as the biggest problems, along with the elimination of impacts of delayed inflation from the previous era (Klaus 1995a).

REFORM MEASURES AND ECONOMIC POLICY

In this chapter, I focus on individual economic reform measures. I will especially focus on the nature of this process, devoting extra space to selected crucial issues (such as privatization or the banking sector) in the following chapters of the book. I will proceed chronologically, from the beginning of the transformation till the end. Logically, I will put emphasis on the early phase of the entire process, when most changes took place. I point out how the implemented economic policy is intertwined with achieved economic results.

4.1 1990–1993: Basic transformation measures

The first transformation year (1990) was the year of preparation. Basic reform measures were implemented starting on January 1 of the following year. It is certainly not surprising, because all partial reforms had to be planned as well. Still, 1990 was definitely not a year of transformation process stagnation. As already mentioned, September 1990 witnessed an event of crucial importance—the approval of economic transformation scenario.¹ Another important institutional development involved changes in the legal framework—laws on private businesses were passed (it only established that private entrepreneurship was not illegal any more),² on joint-stock enterprises, and on state enterprises. Despite these changes, the private sector created only 4 percent of GDP in 1990 (Dyba and Švejnar, 1997). Earlier in the year, the Czechoslovak State Bank (SBČS) was legally separated from commercial banks, and the two-tier banking system was born.

As was explained earlier, one of the key problems in the 1980s was the missing functionality of price mechanism. Prices were fixed and distorted in various ways (e.g., subsidies, negative turnover tax). As a result, the prices did

not fulfill their functions. Therefore the government, in mid-1990, decided to rectify the distortions resulting from the negative turnover tax, especially with groceries. The reformers obviously needed public support for the transformation process and did not want to lose this support in the very beginning. This is why the removal of subsidies was accompanied by the so-called state balancing benefit in the amount of 140 CSK. It was awarded monthly to all Czechoslovak citizens.³ The amount was calculated from an overall sum of the negative turnover tax (i.e., subsidy) and divided among individual citizens. The removal of price subsidies resulted in 24 percent increase in food prices (Holman 2000) and lower demand for it. Later that year, prices of railway fares increased by 100 percent, bus fares by 30 percent and gasoline and fuel prices doubled in the effort to gradually bring it near the market (world) level.

Another problem consisted in the utterly unrealistic setting of the exchange rate. The government and the SBČS carried out several devaluations accompanied by unification of several exchange rates into one (see Table 4.1). The final setting of the exchange rate proved to be difficult and problematic. Intensive disputes were fought about its value and opinions were offered by domestic and foreign experts alike. Foreign recommendations ranged from 20 CSK per dollar (Japanese experts) to 33–35 CSK per dollar (IMF) (see Loužek).⁴ Klaus claims that this was the most difficult decision of the entire transformation (Klaus 2001). Eventually, three devaluations were carried out—by 16.6 percent on April 8, by 55.3 percent on October 15, and by another 16 percent on December 28.⁵ The result was that the rate devaluated from 14.29 CSK at the end of 1989 to 28 CSK at the end of the following year (the crown was revaluated compared to the rouble simultaneously). Foreign exchange quotas were limited during the whole year and businessmen were allowed to buy extra currency at currency auctions.

Table 4.1: Exchange rates of the Czechoslovak crown to the US dollar

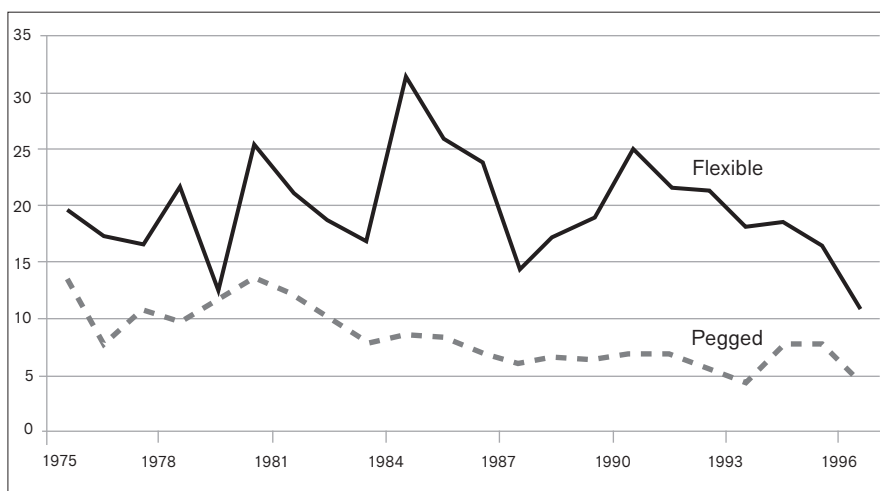
	December 31, 1989	March 31, 1990	June 30, 1990	September 30, 1990	December 31, 1990
Trade	14.29	16.81	16.51	15.71	28.00
Auction	114.35	59.15	39.36	31.04	39.40
Tourist	–	39.96	27.85	26.49	28.00
Black market	43.48	41.49	35.57	33.56	45.65*

*In the following months, the confidence in the crown increased—due to lowered inflation and higher foreign currency reserves and the black market disappeared.

Source: Dobešová et al. (2003).

The government opted for the fixed rate regime and the crown was fixed to the basket of five currencies (see BOX 12). One of the reasons for the decision about the exchange rate regime was fear of inflation. There was empirical evidence that countries with fixed exchange rate regimes had, in the long run, lower inflation (see Figure 4.1). Fixed exchange rate regimes were therefore popular at the beginning of the 1990s.

Figure 4.1: Inflation in developing countries with flexible and pegged exchange rate regimes, 1975–1996 (in %)



Source: IMF (1997).

Due to devaluations, the crown was undervalued at the beginning of the transformation, providing one of the two so-called transformation cushions.⁶ It refers to a situation in which domestic subjects were provided a temporary advantage in the form of undervalued currency. Foreign competition was thus relatively disadvantaged on the Czechoslovak market, while it was profitable for Czechoslovak exporters to sell abroad. On the contrary, the devaluation was undoubtedly an inflation factor and contributed to lower real wages. In the subsequent period, this cushion was being permanently emptied by gradual revaluation of the real exchange rate—domestic prices grew faster than foreign prices, while the fixed exchange rate was maintained (see BOX 23).

BOX 12 Calculation of the exchange rate

Jirges and Plchová describe the process of exchange rate calculation. The first step was to establish central parity and select the currency basket to which the crown would be fixed. The exchange rate—its central parity—was to be set in a way ensuring long-term equilibrium of payment balance. Until May 1993, the Czechoslovak (and later Czech) currency basket contained five currencies. It was replaced by a two-currency basket and the system lasted until the currency crisis in May 1997. The basket composition at the beginning of the transformation is demonstrated in the following table (see also Jirges and Plchová 1996).

Table 4.2: Currency basket for the CZ crown
with individual currency percentages (weights)

currency/date	USD	DM	ATS	CHF	GBP	FRF
December 28, 1990	31.34	45.92	12.35	6.55	4.24	—
January 2, 1992	49.07	36.15	8.07	3.79	—	2.92*
Absolute quotient as of January 2, 1992	0.01761	0.01969	0.03092	0.00184	—	0.00543
Basic (initial) rate CZK	27.86	18.35	2.61	20.57	—	5.37

*The British pound was replaced by the French franc.

Absolute quotient expresses the share of the given currency in one crown—it is derived from the initial rate of the crown toward the basket currencies and their share in this basket—for example $0.01969 \text{ DM} = 1/18,35 \times 0.3615$.

The current exchange rate reflected mutual changes in currency prices on global markets. However, the central parity was maintained. How was the exchange rate to individual currencies calculated? Jirges and Plchová quote an example—let us suppose that currencies on the international currency market (Frankfurt am M.) had the following rates to the dollar on a certain day and hour: 1.564 DM, 10.996 ATS, 1.395 CHF, 5.295 FRF. If we use the aforementioned shares of individual currencies in the basket (in absolute form) and we use the aforementioned quotations, we will get the following:

$$\begin{aligned}
 1\text{CSK} &= 0,01761 \text{ USD} + 0,01969 \times \frac{1}{1,564 \text{ USD}} + 0,03092 \times \frac{1}{10,996 \text{ USD}} + \\
 &0,00184 \times \frac{1}{1,395 \text{ USD}} + 0,00543 \times \frac{1}{5,295 \text{ USD}} = 0,035355 \text{ USD}
 \end{aligned}$$

This means that $1/0.035355 \text{ USD} = 28.28 \text{ CSK/USD}$, which is the crown exchange rate calculated by the CNB from absolute basket quantities and specific quotation of basket currencies exchange rates on the given day. This exchange rate was (in essence) the central parity, from which the exchange rate declared by the CNB could have deviated within the fluctuation band.⁷ In case the fluctuation band was set to ± 0.5 percent, the exchange rate was allowed to deviate from the central parity only within $0.995 \times 28.28 = 28.14 \text{ CSK/USD}$ or $1.005 \times 28.28 = 28.42 \text{ CSK/USD}$. The oscillation band was thus very narrow and the main reason for exchange rate fluctuations relied in varying exchange rates among the basket currencies on global markets.

In May 1993, the CNB limited the basket to only two currencies. There were several reasons—the currency structure of balance of payments current account had changed; the fact that currencies in the basket were mutually fixed (shilling and mark) was taken into account; the CNB also tried to make exchange rate calculations less complicated. The new situation is displayed in the table below:

Currency	USD	DM
Weight (in %)	35	65
Rate to USD	1.000	1.5806
CSK rate	28.443	17.995

The exchange rate for individual days was compiled similarly as for the bigger basket. The absolute form was $1/28.443 \times 0.35 = 0.012305 \text{ USD}$, and similarly for DM $1/17.995 \times 0.65 = 0.036121 \text{ DM}$. The absolute form of the currency basket (and the central parity) was calculated using the following formula: $1 \text{ CSK} = 0.012305 \text{ USD} + 0.036121 \text{ DM}$. The central parity exchange rate was calculated from the momentary development of the dollar-to-German mark exchange rate. If the momentary exchange rate of the dollar against the mark was 1.45 DM/USD , then $1 \text{ CSK} = 0.012305 + 0.036121 \times 1/1.45 = 0.037216 \text{ USD}$, i.e. $1 \text{ USD} = 1/0.037216 = 26.87 \text{ CSK}$. The announced exchange rate was allowed to deviate from this value within the fluctuation band (± 7.5 percent since February 1996). Exchange rates of other currencies were calculated in relation of these values to the dollar (mark), as quoted on exchange rate markets. For more on the exchange rate calculations, see Jirges, Plchová (1996).

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The economists' concerns regarding the balance of payments stability were certainly justified, because Czechoslovak foreign currency reserves at the end of 1990 covered only one-month imports (Boresztein and Masson, 1995). The crucial measure benefiting the stability of the balance of payments was the setting of the exchange rate. In an effort to strengthen the position of the crown and to improve the stability of the entire system, the state accepted a loan from foreign institutions in the amount of 1,855,000,000 dollars.⁸

The property restitution process was launched at the end of the same year.⁹ This measure was also intensely discussed. Some economists even signed a petition against restitutions (Mlčoch 2000). It was eventually decided that only the property confiscated after the 1948 communist coup d'état would be returned to its original owners. Moreover, the restitutions were limited to Czechoslovak state citizens and churches (under special circumstances). (For more on restitutions, see Chapter 7.)

BOX 13 Monetary aggregates

To represent the amount of money in the economy, central banks monitor the so-called monetary aggregates. The CNB distinguishes four aggregates: M0, M1, M2, and L. M0 consists of currency (bank notes and coins) in crowns, held by households and enterprises. M1 consists of M0 aggregate plus nontime bank deposits. M2 consists of M1 plus time and foreign currency deposits. L consists of M2 plus state treasury bills held by domestic nonbanking persons.

A simplified way to explain the relation between monetary aggregates and price growth based on the equation of exchange is such: an increase in the amount of money in the economy results (*ceteris paribus*) in long-term in higher price levels.

The uneasy responsibility of becoming the head of the Czechoslovak State Bank in the era of transformation was assumed by Josef Tošovský in December 1989. The economic policy in 1990 was restrictive. Both the SBČS and the commercial banks had to struggle with their own ignorance of the functioning of the market system. The SBČS, for example, did not (and could not) set a reasonable estimate about the optimum amount of loans in the economy. Fears of inflation pressures were the only thing that everyone agreed on. Restriction was a logical result (the discount rate was increased from 4 to 8.5 percent, obligatory minimum reserves increased similarly), as well as emer-

agency measures that are not used in standard market economies; for example credit ceilings (see BOX 14). For enterprises, the situation changed dramatically, because under the previous regime they were accustomed to being awarded credits automatically. The SBČS opted for monetarist mechanism as the basis for its monetary policy. Monetary targets were to be achieved through an intermediate target—the monetary reserve. There were several reasons for this decision—the natural model for the SBČS was the Bundesbank (one of the most successful central banks in the world), which had been implementing this policy for a long time; the policy was very popular at the time; its implementation was quite simple; and it was recommended by the IMF (Hampl 2001). The central bank targeted the monetary aggregate M2 (see definition in BOX 13) in particular (Jonáš 1997).

BOX 14 Monetary policy instruments (Part I)

Monetary policy uses direct and indirect instruments to achieve its goals. The first group of instruments consists of directive and administrative measures. These instruments are rarely used in modern market economies. They include liquidity regulations (determination of the structure of bank assets and liabilities), credit ceilings (absolute and relative loan limits), obligatory deposits with the central bank, and the so-called gentleman's agreements (personal recommendations from the central bank). In addition, the central bank may also use indirect instruments—operations used by the central bank in an effort to influence the functioning of the currency market. These are unfocused and blanket instruments that include open market operations (i.e., purchasing and selling of securities), determination of minimum obligatory reserves, interest rates announcement, and various operations on the foreign exchange market.

Direct instruments are quite effective, with minimum expenses for the central bank. The functioning of these instruments is independent of the currency market effectiveness. By contrast, these instruments may be counterproductive and cause economic imbalance, because they stand outside the market. Kvizda claims that these instruments are suitable in situations when the currency market does not work (Dobešová et al. 2003). This was exactly the situation at the beginning of the transformation—the currency market functioning was limited, both among commercial banks (lack of competition) and between commercial banks and their clients. As a result, the functioning of the entire mechanism was limited and the central bank used direct

instruments, especially in times of credit ceilings, which meant the status quo preservation for the banks (Jonáš 1997).

The direct setting of minimum interest rates on deposits was abandoned in May 1990. In theory, banks could set any rates they wanted, but the central bank exerted moral pressure to make real interests on the deposits positive (Jonáš 1997). Besides, the central bank used the so-called refinancing credit in the initial years of transformation, giving commercial banks relatively easy access to loans. The central bank provided loans for one to three months in the form of auctions; banks that did not succeed still had a chance to be awarded a refinancing loan for one-to-seven days with a predeclared fixed interest rate derived from the discount rate, in the maximum amount of double value of their capital. The refinancing loan was a nonstandard measure and it was later abandoned like the credit ceilings. Jonáš evaluates the use of direct instruments in early stages of the transformation as successful, because the price level was stabilized quickly (Jonáš 1997). In 1992, the central bank started to carry out open market operations—the SBČS bonds were emitted in the first few months due to the lack of state securities (Vencovský 2003).

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Just like monetary policy, fiscal policy was restrictive. The government limited its spending compared to previously approved budget and the budget was drawn up in surplus. The cancellation of subsidies for enterprises was an important part of the restriction. It should also be mentioned that in 1990 Czechoslovakia once again became a member of the World Bank and the IMF.

If I was to single out a date that was crucial for the implementation of the economic transformation, it would be January 1, 1991. This was a milestone day, when all key liberalizations (of prices and trade) took place. Numerous other reforms followed.

Price liberalization was the key factor in the entire transformation process (see BOX 15). If markets were to function, it was essential that prices provide relevant information. The liberalization meant that the state had to give up intervening in price creation. Since January 1, 1991, 85 percent of prices were liberalized (Dyba and Švejnar 1997). Prices grew because of suppressed inflation from the previous era. The measure was not politically popular, but without price liberalization it was practically impossible to do business and the market mechanism would not be able to work. A surprising percentage of people approved of it (see Table 4.3). However, only 5 percent agreed with

the method of implementation and most people were surprised by the price development. Differences between the two parts of the federation were quite remarkable.

Table 4.3: Answers to the question: "Do you think that price liberalization was necessary?" (June 1991)

	ČSFR	CR	SR
Strongly agree	36	42	26
Agree	40	40	40
Disagree	16	12	23
Strongly disagree	8	6	11

Source: Miková (1992).

BOX 15 Price liberalization and subsequent price deregulations

Price liberalization was a factor in reform plans from the very beginning, although not all economists approved it (Klaus 1995a). Some were afraid that domestic monopolies would abuse the situation, and they wanted to create a market structure first and then liberalize the prices. Klaus observes that the other economic policy measures, such as the liberalization of foreign trade, restrictive economic policy and fixed exchange rate, eliminated the danger. On the contrary, Kožušník claims that the liberalization was implemented without excessive discussions (Kožušník 1997). Most economists understood that the measure was inevitable. Price controls remained in force for food, rent, heating, and public transportation. The government was more cautious about monopolies in these areas. Food prices were temporarily regulated because of concerns of monopolistic behavior (Jonáš 1997). Hanousek and Krkoška observe that liberalization can be conceived as gradualist or shocking (Hanousek and Krkoška 1997). Hungary chose the former, while Poland opted for the latter. Czechoslovakia (and the Czech Republic) adopted the "golden middle way."

It is difficult to ascertain exactly what proportion of prices was in fact liberalized.

The government often boasts that 95 percent of prices are not regulated. However, if we take a closer look at the consumer basket, the situation is not so bright and we will not be far from the truth if we estimate the share of subsidized prices in the

basket at 20–30 percent. We would like to draw attention to the obvious fact that we must consider the weight of individual consumer expenses, where rent, electricity and water are very important. (Hanousek and Tůma 1994)

Table 4.4 shows similar results. Yet the administratively set prices of commodities kept growing. In mid-1991, prices of coal grew by 240 percent, gas by 100 percent, and heat by 320 percent, especially after cutting down of price subsidies (Jonáš 1997). Prices of housing (rents in particular) also remained regulated. Klaus presented several arguments for delaying rent deregulation: housing is not a normal commodity, because there are no substitutes; low supply would shoot the prices up unbearably; and the state would have to subsidize those who would not have money to pay market rents (Klaus 1994). Plus, the measure would be hugely unpopular, I might add. Conversely, he was aware of the impact regulation expenses had on the owners. Although the right-wing governments planned the rent deregulation, its progress was slow. There was no rent deregulation between 1991 and 1996—nominal wages (and incomes in general) grew faster than the cost of housing—and “ironically, early in 1997, the portion of income spent on housing was lower than two years ago” (Hanousek and Krkoška 1997).

Table 4.4: Share of administratively defined prices, 1991–2003

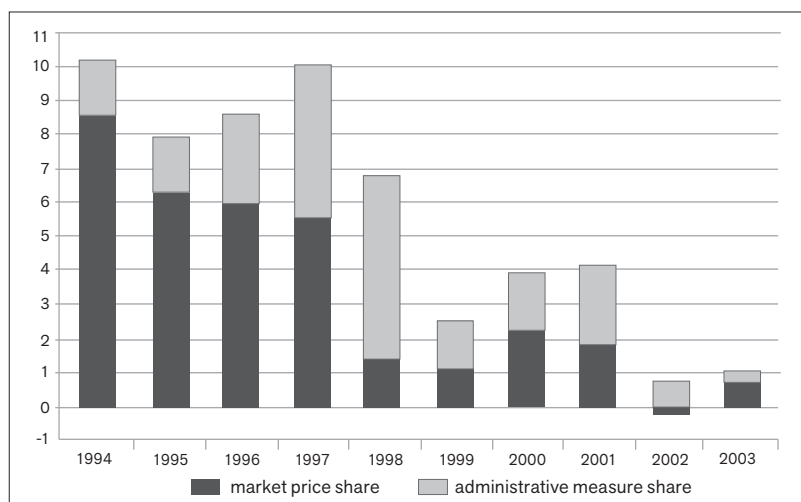
	1991	1992	1993	1994	1995	1996	1997
Share of administratively set prices in CPI in %	27.9	18.3	17.9	18.1	17.4	17.4	13.3
Products with administrative prices in EBRD-15 basket	9.0	5.0	5.0	4.0	4.0	4.0	2.0
	1998	1999	2000	2001	2002	2003	
Share of administratively set prices in CPI in %	13.3	13.3	13.3	12.4	12.4	10.9	
Products with administrative prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	1.0	

Source: EBRD (2000, 2003).

Slow deregulation was also discussed after the 1997 economic crisis. Schwarz thought that unfinished liberalization of telecommunications, energy, gas, heat, and rent was one of the causes of economic problems (Schwarz 1998). Market functionality was restricted, resulting in asymmetric impacts on individual branches and interest groups.

However, the process of price deregulation continued. Even the 2003 results show that a significant portion of prices in the Czech Republic was still regulated. Nevertheless, the situation in housing changed; according to the Czech Statistical Office, a member of an average household spent approximately 16,650 CZK for accommodation, representing 18.2 percent of his total income. Ten years before, the amount was approximately 5,620 CZK, that is 13.8 percent of net expenses and, in 1990, the share of housing expenses was less than 11 percent. The largest share of total housing costs is spent on electricity and gas. Between 1995 and 2003, this amount almost tripled. According to the Czech Statistical Office (ČSÚ), rent and other related services represent much lower share, and it increased only 2.6 times during the same period. Heating and hot water expenses also play an important role. These costs grew the slowest—by 65 percent. The final deregulation of rents took place in 2012. See Figure 4.2 for impacts of deregulation during transformation.

Figure 4.2: Consumer prices broken down to market price share and regulated price share, 1994–2003

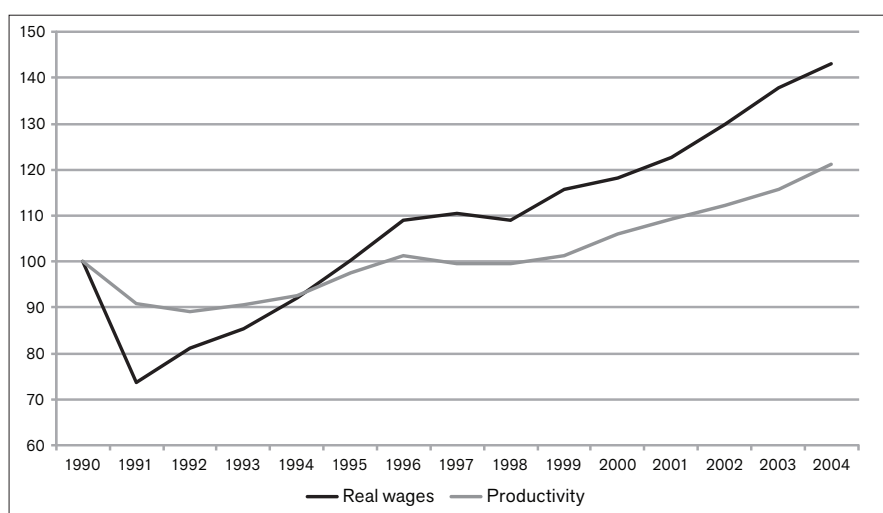


Source: Makroekonomická predikce červen (2004).

Holman reminds us that after the price liberalization, no one knew where the balanced level was (Holman 2000). In the initial phase, prices “looked for” these levels. The price liberalization naturally resulted in changes in relative prices and in the consumption structure. Economic policy faced huge

problems. It was therefore very important that the price level growth came to a halt soon and the prices stabilized. Nevertheless, the price growth in the initial months exceeded household income growth significantly, resulting in year-to-year drop in real wages by more than 25 percent (see Figure 4.3).¹⁰ This fact provided the second transformation cushion—the wage cushion. Its subsequent emptying depended on the growth rate of real wages.¹¹ The government tried to slow down the (unfounded) inflationary growth of wages by wage regulation (see BOX 19).

Figure 4.3: The development of real wages and productivity (1990=100)



Source: ČSÚ (2012).

Liberalization of foreign trade was carried out hand in hand with the price liberalization. Its purpose was to improve supply for households and enterprises and to create competitive pressure on domestic monopolies. Foreign trade was liberalized (it was allowed to import and export products freely) and the duties were lowered to 5 percent on average (Jonáš 1997). Internal convertibility of the crown was implemented (see BOX 16). As a countermeasure, the government introduced a 20 percent import surcharge, for fears of rapid increase in imports,¹² which might have potentially threatened the payment balance and the fixed exchange rate, which was used as the basic anchor for the entire transformation process.

BOX16 Internal convertibility

Internal convertibility is a limited convertibility for transactions on the current account. It is not a clearly defined term (for a discussion on this topic, see for example Greene and Isard 1995). In the Czechoslovak case, anyone who wanted to import merchandise from abroad was allowed to buy foreign currency from the central bank at the given exchange rate. However, all exporters were obliged to sell the foreign currency they acquired to the central bank. Capital transfers were liberalized only partially and were subject to the central bank authorization—this applied to direct foreign investments, portfolio investments, and revenues. Vencovský also mentions obligatory consultation of payment conditions for large volume imports (Vencovský 2003). Citizens had limited access to foreign currency—2,000 CSK/person per year (roughly 50 USD) in 1990—and the transaction was recorded in the passport. This amount increased in the following years (see Table 4.5).

Table 4.5: Limits for purchase of foreign (convertible)
currencies for a Czech(oslovak) citizen, December 1989–October 1995

Date	Amount (CSK, CZK)
since December 5, 1989	500
January 14, 1990	2,000
January 1, 1991	5,000
January 1, 1992	7,500
January 1, 1993	7,500
January 1, 1994	12,000
January 1, 1995	100,000
October 1, 1995	limits for purchase of foreign currencies were abolished

Source: ČNB (2011).

As was already mentioned, one of the main economists' concerns of the era was related to uncontrollable price growth. It is therefore not surprising that the economic policy supported by the IMF continued in the restrictive trend (see the debate about the restrictions in BOX 17). In the fiscal sphere, subsidies to enterprises were further limited. However the government founded the Consolidation Bank to take over liabilities from the previous system (see BOX 51). The budget was in deficit,¹³ but the deficit was low, especially compared to neighboring countries. The reasons for the deficit included decrease in restriction in the form of lower indirect taxation (by 10 percent) and the import

surcharges introduced at the end of April. The relaxed regime was a result of the higher than expected budget surplus at the beginning of the year (Klaus 1991). There were also modifications in taxation, with turnover taxes reduced from the previous 1,500 different rates to four—0, 12, 22, and 32 percent.

BOX 17 Debate on restriction in early stages of transformation

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The dispute between gradualist and shock approach resurfaced in differing opinions concerning the extent of restriction that accompanied the initial economic reforms. Opponents of excessive restriction advocated slower reforms in general (e.g., Levčák 1992; Sojka 2000). Levčák proposed an alternative program focusing on economic renewal based on state expenses, foreign investment support, restructuring, export support, implementation of structural and industrial policies, and liberalization of demand restrictions (Levčák, 1992).¹⁴ Some expressed doubts about the initial extent of restriction (Kožušník 1997; Myant 2003).

Others, however, defended restrictions. Holman, for example, reminds us that in the initial era (1990–1993) nobody knew how strong the restriction should be, and claims that the fact that the prices remained under control was a great success (Holman 2000). It is also not surprising that Klaus considers the extent of restriction to be justified and writes that the government was under the strong pressure to loosen it (Klaus 1992). Hampl also writes about the extent of restriction positively, pointing out the Central Bank and its lack of experience (Hampl 2001). Another restriction advocate presents similar arguments, claiming that in the given era, nobody knew how the economy behaved, and the central bank had little credibility and scarce foreign exchange reserves (see Jonáš 1997).

I find the remarks about the lack of knowledge concerning the functioning of a free economy (of all people involved in the economic policymaking) to be apt. Under such conditions, it is very difficult to set the extent of restriction precisely. Hard data also disproves the argument that the economic policy was too restrictive. Let us not forget that the planned inflation for the year 1991 was of 30 percent. Reality exceeded the expectation by almost twice as much. Lower restriction would result in even higher prices.

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The monetary policy was also strongly restrictive (see BOX 18)—for example discount interest rates increased by 10 percent at the beginning of the year.¹⁵

There were several reasons, but the crucial one was the effort to prevent inflation spirals. Another factor was the general lack of experience of the central bank, related both to economic theory and everyday practice (Hampl 2001). However, one positive detail of that time was the fact that the central bank was *de facto* utterly independent since inception of the transformation process.

BOX 18 Stabilization policy

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It is clear from what I have said so far that the stabilization policy was implemented hand in hand with the reforms. In general, the stabilization policy can be either orthodox or heterodox. The orthodox policy is based on strictly applied classical monetary and fiscal restrictions, while the heterodox policy is supplemented with price and income policy, with the aim to eliminate inflation pressures. The heterodox policy was definitely applied in Czechoslovakia, as described in other sections of this book. However, the policy implemented in the CR was predominantly orthodox, especially when compared to economic policies in such countries as Mexico or Israel (Klaus 1994).¹⁶
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Concerns of inflation were so intensive that the government resorted to wage regulation, being especially afraid of state enterprises' behavior. On the concrete level it assumed the form of extra taxation once the wage growth exceeded a certain limit (Holman, 2000; see also BOX 19). Welfare policy also developed with time. The government, in effort to preserve popular support, started building the social safety network more intensively in order to dampen adverse impacts of the transformation on the population (Slaný 2003). Trade unions remained quite supportive, owing to low unemployment and participation in three-party negotiations.

BOX 19 Wage regulation

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Wage regulation was introduced several times during the first phase of transformation (after 1991), due to fears of rapid growth of wage expenses that might set the inflation wage spiral in motion. The regulation was first introduced on January 1, 1991, but was abandoned in the first half of 1992, followed by intermittent periods until 1995, until it was removed completely. There were partial differences within the individual periods—in 1992, the regulation did not apply to private subjects, while added value index was later also used as a basis (for more on specific conditions, see Dyba and Švejnar 1997; Klaus 1995; Polívka 1994).

The following so-called regulation formula was used:

$$\text{wages}_{1993} \leq \text{wages}_{1992} \times \frac{\text{sales}_{1993}}{\text{sales}_{1992}}$$

In other words, an enterprise that increased sales by 100 percent was allowed to increase wages by 100 percent. The regulation also accommodated to the situation of enterprises that implemented a growth program, hired employees and increased wages. Punitive taxation came only when the difference between the left and right sides of the formula exceeded 15 percent. The relation looked as follows:

$$\frac{\text{wages}_{1993}}{\text{wages}_{1992}} \leq 1,15 \times \frac{\text{sales}_{1993}}{\text{sales}_{1992}}$$

(Klaus 1994).

Despite its relatively benevolent conditions, the wage regulation was frequently criticized, both from the left and the right. Trade unions were initially in favor, but later turned against this measure. Some economists pointed out deformations caused by the regulation (for example, Hanousek and Tůma 1994), claiming that the pressure of wages on prices was not too significant, but assessed the measure as a positive signal for market subjects.

Klaus also admitted that it was a nonstandard measure, but he believed it was impossible to wait “until the economy settles” and starts working normally (Klaus 1994).¹⁷ Wage regulation was reintroduced as soon as wages grew too fast against work productivity, which may have led to the loss of competitiveness¹⁸ and currency devaluation pressures.¹⁹ He says elsewhere that the wage growth was a result of a combination of several factors—pressure of trade unions; weak management (owners) unable to withstand the pressure; due to the shortsighted vision of the world (notion that the wage growth will somehow hide in the price growth); or as intentional weakening of enterprises (in situation, when privatization was not finished, founding ministries behaved like weak owners and the main owner—the National Property Fund [FNM]—did not behave like an owner). Tuček, for example, notes that it was strange how easily the wages grew even in companies on the verge of bankruptcy, such as the colossal companies ČKD, Škoda Plzeň, or Svit Zlín (Tuček 2000).

Klaus demonstrates that in 1992 and in 1993, the regulation functioned—as regulation was introduced (in the second half of the year), price growth was

much slower than in the first six months (Klaus 1994). Similarly, Holman believes that the regulation led to modest wage growth (Holman 2000). On the contrary, Kožušník claims that the regulation had a relatively minor impact, because ceilings were set very high (Kožušník 1997; see also Klaus 1995). One scholar notes that the entire regulation was nothing but a scarecrow, because there were several ways how to avoid it (Polívka 1994). The fact is that after the end of regulation, the wage growth tempo exceeded the work productivity tempo, which was perceived as a factor in the subsequent loss of competitiveness and in the deficit of the current account.

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January 1991 marks the beginning of the privatization process, when the so-called small privatization was launched. In this process, mostly trades, services, and small enterprises, such as restaurants and stores, were auctioned and sold (more on small privatization in chapter 7.2). Disintegration of eastern markets had a serious impact on the economic development (and economic policy) in 1991 and in the following years (Table 4.6). These markets were the target for most Czechoslovak exports during the dictatorship era. As a certain counterbalance to this development, the government negotiated the association treaty with the EC, which involved the liberalization of mutual trade.

I will discuss the economic results in the next chapter, but the year 1991 was so important that I must quote basic macroeconomic aggregates as well.

Table 4.6: Basic economic indexes in 1991

	I quarter	II quarter	III quarter	IV quarter	Year
GDP	-3.0	-12.8	-21.5	-25.2	-15.9
Unemployment	1.7	2.6	3.8	4.1	4.1
Inflation	39.3	47.9	47.9	51.5	51.5
Industrial production	-9.9	-22.3	-39.6	-35.8	-24.4
Employment in industry	-7.6	-10.1	-13.4	-15.3	-11.6
Private income	-30.4	-31.8	-26.7	-15.7	-25.5
Private expenses	25.7	-33.8	-32.0	-32.9	-31.3
Trade balance	-6.9	9.6	14.4	11.9	4.5

Note: GDP and industrial production in constant prices of 1984, industrial production in enterprises with over 100 employees, GDP for Czechoslovakia as a whole, inflation—CPI at the end of period, trade balance is the percentage of the Czechoslovak GDP in a given period.

Source: Myant (2003).

In 1992, economic changes were not as dramatic as in the previous year. But the entire economic development was overshadowed by parliamentary elections and subsequent negotiations about the division of the country. This political aspect had a significant impact on the economic policy. The crucial economic event of the year was the launching of the first wave of mass privatization with the dominant voucher method.²⁰ This form of privatization consists of transferring property to citizens who invested their vouchers (using their own discretion) into enterprises or investment funds and thus became shareholders. Essential restitutions also took place in this year (Slaný 2003). Legislation also underwent substantial changes; the parliament passed the new Commercial Code, the Trade Law, and the Antimonopoly Law.

The fiscal policy continued to be restrictive—the budget ended up practically balanced. Another noticeable characteristic was the limitation of expenses as a percentage of the GDP.²¹ Monetary policy remained the same. In the first half of the year, the central bank believed that inflation tendencies did not represent a serious threat to the economy and alleviated monetary restriction by lowering interest rates. The bank used these measures in the effort to restore economic growth. However, in the second half of the year, interest rates were increased again.²² Negative expectations and insecurity related to the crisis of the federal state were to blame. A narrow oscillation band was introduced for the crown (± 0.5 percent) and the currency basket to which the currency was tied, was limited to two—the German mark and the US dollar—and the role of the mark was strengthened to 65 percent. Fears of inflation pressures pushed the government to reintroduce wage regulation in the second half of the year, but only in enterprises where the state held the majority share (over 50 percent).

Nineteen ninety-three was primarily the year of the division of the federal state. The common currency survived only until February. The country's separation was accompanied by considerable expenses on both sides and it slowed down economic recovery (for details, see BOX 20).

BOX 20 Monetary separation

Both governments wanted to preserve the common Czechoslovak currency for some time. The initial plan was to maintain the crown for at least six months, but these plans were soon proven to be unrealistic and the currency lasted for only thirty-eight days, mainly due to the lack of market confidence in its future and the conviction that the Slovak economy needed devaluation (Jonáš 1997).

Such opinions in both successor countries led to added pressure on foreign currency reserves (in the CR, the slump related mainly to the Central Bank, in Slovakia to the entire banking sector).²³ Other symptoms included the January drop of the parallel exchange rate of the crown abroad, while some foreign financial institutions ceased to accept the Czechoslovak currency completely. The monetary arrangement treaty, signed in October 1992, contained clauses with defined conditions of withdrawal from the treaty, including (among other) the drop of foreign currency reserves under the level of a monthly import, budget deficit levels (should not exceed 10 percent of revenues), or the inability to coordinate the monetary policy (Janáčková 1995). Janáčková claims that these conditions were already met in January 1993. Jonáš claims that the Czech foreign currency reserves fell under the level of two-week imports in early February (Jonáš 1997).

Under such conditions, both governments agreed on monetary separation and the parliaments passed relevant laws on February 2. The separation was implemented in the next four days. The basic method used in the CR was stamping banknotes.²⁴ The decision was to stamp the banknotes in nominal values of 100, 500, and 1,000 CSK.²⁵ The state security printer supplied new 200 CZK banknotes. Citizens were allowed to exchange 4,000 CZK in cash (1,000 CZK for every person under fifteen years of age) and had to deposit the rest into banks. The money was exchanged at a 1:1 ratio; citizens did not lose anything, and the monetary separation was neutral inflation-wise. There were approximately 4,000 exchange offices in the country (the State Post Offices and the Česká Spořitelna savings bank branches) and the money exchange was confirmed by a stamp in IDs. Banknote stamping was carried out in Komerční Banka (KB) branches and in the CNB. The separation was a technically demanding operation and it proceeded better than expected. Its execution was also appreciated abroad (for details, see Prokop 1995). Janáčková assesses the short period with a common currency positively, claiming that it provided time to settle the public opinion down and get prepared for the separation (Janáčková 1995).²⁶

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In the Czech Republic, the transformation appeared to be successful, at least on the macroeconomic level—the economy was stabilized and recovering. The situation on the micro level, however, was perceived as worse (e.g., Bokros 2001),²⁷ as the transformation had harsh consequences for many enterprises. The so-called secondary insolvency represented a serious

problem as well.²⁸ The banking sector faced difficulties, as it was affected with the first wave of small bank bankruptcies (for details, see chapters on enterprises and banks).

In economic practice, the principal event of the year was the tax reform implemented in the early months. It modified the entire tax system to accommodate to the emerging market environment. The government abolished the sales tax and introduced new taxes—the value-added tax (VAT) and income taxes for legal and physical persons. Tax rates imposed on market subjects were lowered and the system progression was limited.²⁹

The process of small privatization was terminated in 1993 and the shares from the first wave of voucher privatization were issued. Once the shares were issued, the Prague Stock Exchange opened for trading,³⁰ hand in hand with the so-called RM-SYSTEM.³¹ The budget at the end of the year was balanced—a unique achievement for any economy in Central and Eastern Europe. No dramatic change occurred in the monetary policy after the separation (only the indirect instruments were slowly gaining importance). Josef Tošovský once again was named governor of the Czech National Bank in January 1993.³² The fixed exchange rate still served as an anchor of the economy, but some of its downsides already began to surface. The inflow of foreign capital, which started to gain momentum starting in 1993 meant that the central bank had to focus its policy on the exchange rate maintenance, which restricted the autonomy of monetary policy in practice.³³ In the spring of 1993, inflation tendencies intensified, mainly as a result of the tax reform. In reaction, the monetary policy was restrictive.

BOX 21 Monetary policy instruments (Part II)

After the initial stabilization, the CNB began to use standard monetary policy instruments. The CNB uses three types of instruments—open market operations, automatic facilities, and mandatory minimum reserves. The open market operations are used for steering interest rates. They are mostly executed in the form of repo operations, the principal monetary instrument. The CNB accepts surplus liquidity from banks and, in return, transfers eligible securities to them as collateral. The two parties agree to reverse the transaction at a future point in time, when the CNB (as the borrower) repays the principal of the loan plus interest and the creditor bank returns the collateral to the CNB. The basic duration of these operations is fourteen days. The CNB conducts variable rate tenders, which means that the declared repo rate serves as the

maximum limit rate at which the banks' bids can be assured in the tender. The bids with the lowest interest rate are assured as having the priority by the central bank.

Automatic facilities are used for providing and depositing liquidity overnight. As, from the banks' points of view, these represent standing facilities for depositing or borrowing money, the interest rates applied to them form the corridor for short-term money market rates (as well as for the two-week repo rate). The deposit facility is a noncollateralized standing facility, which banks may use to make overnight deposits of surplus liquidity with the CNB—the deposits are remunerated at the discount rate, which generally provides a floor for short-term interest rates on the money market. The central bank lends the bank (overnight) money in the form of repo operation—the interest rate applied to this facility is the Lombard rate providing a ceiling for short-term interest rates on the money market.

The third instrument is obligatory minimum reserves. Every bank that has a banking license in the Czech Republic is required to hold a pre-specified volume of liquid funds—known as minimum reserves on its account with the CNB. Since August 2001, the funds on this account have been remunerated at the CNB two-week repo rate. For more on CNB monetary instruments, visit the CNB website (CNB – www.cnb.cz).

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The government believed that wage increase played a role in the price growth, and it therefore reintroduced wage regulation in the second half of the year.³⁴ The regulation took effect without any explicit approval of trade unions and employers and it applied to all enterprises (including the private sector) with more than twenty-five employees (Dyba and Švejnar 1997). Some authors believe (for example, Tomeš 2000) that despite this restriction, wage growth was still an inflation factor after 1992. The last important event that occurred this year was the welfare system reform—sick benefits, social security, and unemployment benefits.

4.2 1994–1996: Growth phase

The years 1994–1996 can be perceived from several standpoints as the most successful in the entire transformation. The economy grew fast, while inflation and unemployment remained low. The Czech Republic was perceived as the leader among the transforming countries. However, as time passed, darker

sides of this development began to resurface; the imbalance in the current account of the balance of payments provoked doubts about the stability of the entire balance of payments and the exchange rate.

The economic results of 1994 were encouraging. The economy fully recovered from the transformation-induced recession and achieved solid growth. The second wave of voucher privatization was launched.³⁵ The GDP share of nonpublic sector exceeded three-fifths at the end of the year (*HN 2000 Yearbook* 2000).³⁶ The inflow of foreign capital made it possible to pay the IMF loan early,³⁷ but it also became a source of growing problems for the central bank monetary policy. The CNB was forced to perform foreign currency interventions in an effort to maintain the fixed exchange rate. Higher foreign currency reserves allowed the CNB steps in the direction toward liberalization of capital transfers. In particular, companies were permitted to open accounts in foreign currencies and their obligation to offer foreign currency to the central bank was terminated. At the same time, the limits on purchasing foreign currencies by households were increased to 12,000 crowns (approx. 400 USD) per person and year.

The fiscal position appeared to be healthy and the budget was in surplus. But while writing about the growing structural deficit of this era, Horská says that without the privatization income, the budget would be in deficit (Horská 2001; see also BOX 22). One of the reasons was the fact that the government, in line with its political orientation, lowered taxes. A potential dangerous imbalance was also present in wages, whose nominal growth was higher than the growth of work productivity (Tomeš 2000).

BOX 22 Fiscal policy of right-center governments

In the course of transformation, fiscal policy changed dramatically as it had to accommodate the needs of the market economy. Let us not forget that during the communist dictatorship, the fiscal policy was related to high taxation, a complex tax system, a high number of social transfers, subsidies, and high military spending. However, the tradition of balanced budgets also played its role.

The main goal of fiscal policy in the initial stage was to stabilize the economy. The fiscal policy was therefore rather restrictive, as you may see in Table 4.7.³⁸ Besides, the right-center governments also wanted to weaken the role of the state in the economy (Dlouhý 1999). This effort consisted of lowering taxation hand in hand with expenses (Kožušník 1997), for example subventions for enterprises and the military (see BOX 7).

Table 4.7: Budget in 1990–1992 (in millions of CSK)

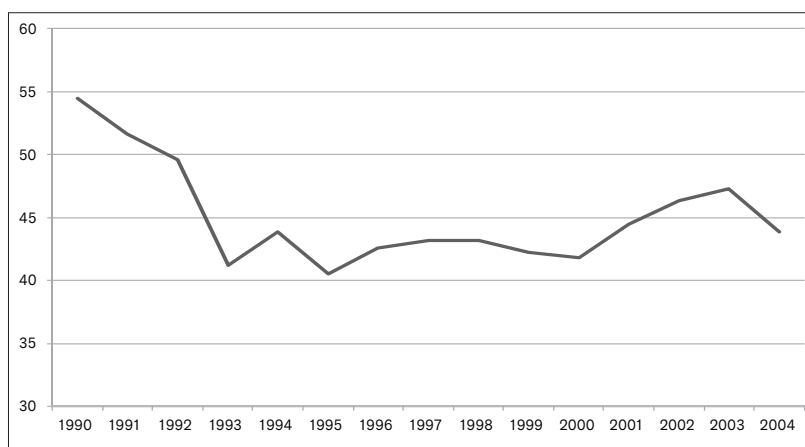
	Federal	CR	SR	ČSFR*
1990				
Revenues	92.017	127.800	76.378	296.195
Expenses	88.002	127.568	76.846	292.416
Balance	4.015	232	-468	3.779
1991				
Revenues	124.034	156.412	108.902	389.348
Expenses	117.645	170.029	119.130	406.804
Balance	6.389	-13.617	-10.228	-17.456
1992				
Revenues	119.015	217.693	115.190	451.898
Expenses	126.015	219.390	123.123	468.528
Balance	-7.000	-1.697	-7.933	-16.630

* ČSFR—the total state budget, consisting of federal, Czech and Slovak budgets.

Source: Czech Statistical Office (1993).

Having overcome the transformation recession, Klaus's government continued in decreasing government expenses while keeping the budgets balanced. Overall, they succeeded and the role of the government redistribution sharply declined during the first years of the transformation, as demonstrated in Figure 4.4.

Figure 4.4: General government expenditure, 1990–2004 (% of GDP)



Source: Antal, Hlaváček, and Holub (2008).

Similarly, the government succeeded in keeping the budgets balanced or in surplus until 1996. In this regard, the Czech Republic was an exception in the region (Dyba and Švejnar 1997). I should stress that contrary to other countries in the region, the stable budget was achieved without monetization of deficit. Jonáš cited several reasons why the government managed to keep the budgets balanced—revenues decreased, but remained high enough to cover welfare spending; tax discipline was comparatively solid; the state debt was low, resulting in low debt service payments (compared to Poland or Hungary); and welfare spending, compared to other countries (Poland) was quite low (Jonáš 1997). I should also mention the economic growth that occurred after the recovery from the transformation recession, which brought higher tax revenues. See development of budget and state debt in Table 4.8.

Table 4.8: State budget and state debt,* according to the ČSÚ methodology, 1993–2004

		1993	1994	1995	1996	1997	1998
Budget balance	billions of CZK	1.1	10.4	7.2	-1.6	-15.7	-29.3
Budget balance/GDP	%	-	-	0.5	-0.1	-0.9	-1.5
State debt	billions of CZK	158.8	157.3	154.4	155.2	173.1	194.7
State debt/GDP	%	-	-	10.5	9.3	9.7	9.9

		1999	2000	2001	2002	2003	2004
Budget balance	billions of CZK	-29.6	-46.1	-67.7	-45.7	-109.1	-93.7
Budget balance/GDP	%	-1.5	-2.1	-2.9	-1.9	-4.3	-3.4
State debt	billions of CZK	228.4	289.3	345.0	395.9	493.2	592.9
State debt/GDP	%	11.2	13.5	14.9	16.4	19.3	21.6

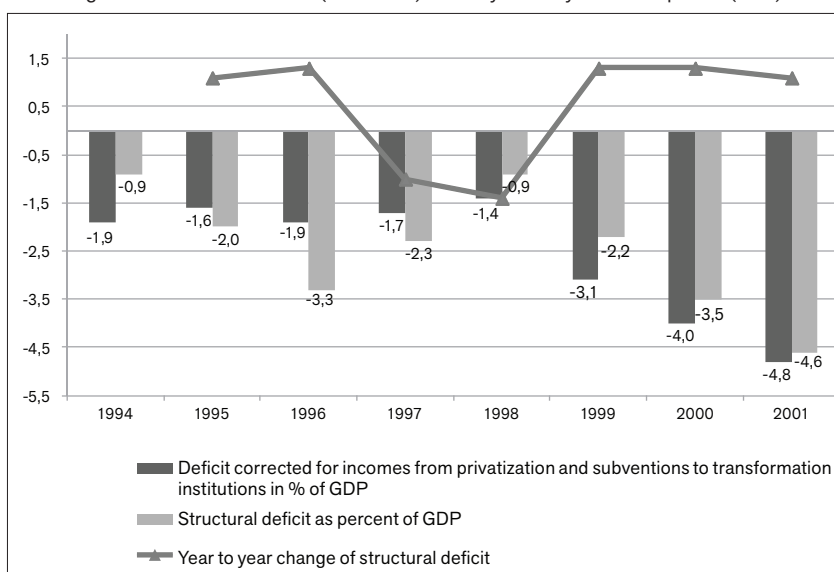
* state debt is the federal government's debt.

Source: Czech Statistical Office, 2005.

Although the budgets were balanced, most analysts believed that the fiscal policy in this period was not restrictive. For instance, Horská claims that the policy was expansive and added 1–2 percent to the economic growth between 1993 and 1996 (Horská 2001). In parallel, Sojka describes the fiscal policy as progrowth, but not deficit-causing, because the government invested in infrastructure, among other things (Sojka 2000). He also reminds us that there was a public debate in this stage about the possibility of incorporating balanced budgets in the constitution. According to Schwarz, fiscal restrictions were eased up in 1995 and were replaced by fiscal expansion before the

elections in 1996 (Schwarz 2003). Moreover, public budgets were gaining in size due to expanded activities of transformation institutions, including the National Property Fund and the Consolidation Bank. Bezděk and Král present an analysis that claims that the fiscal policy until 1997 contained expansive elements (Bezděk and Král 2001). Its results are clearly visible in year-to-year changes in the structural deficit (see Figure 4.5).³⁹ The figure also shows that the budgets were balanced only formally because the structural deficit was quite substantial.

Figure 4.5: Structural deficit (% of GDP) and its year-on-year development (in %)



Source: Bezděk and Král (2001).

According to Sommer and Tůma, the fiscal policy appeared to be conservative, but this conservativeness was often just imaginary (Sommer and Tůma 1999). They also affirm that between 1993 and 1998, 300 billion crowns were allowed into the economy in the form of hidden debt and expenses for the cleaning of the banking sector. Moreover, revenues from privatization were diluted in the economy. Between 1993 and 1999, the real deficit of public budgets was 1 to 4 percent of GDP higher than the admitted deficit and it amounted up to 6 percent of GDP (Horská 2001).⁴⁰ Sojka confirms that the budget was in fact in deficit because it included revenues from privatization,

but it did not cover deficits in transformation institutions (Sojka 2000). Nevertheless, the budget remained more or less balanced until 1997, formally that is. Government expenses and debts were also in decline throughout the entire era—the debt dropped from 18.8 percent of GDP in 1993 to 13 percent in 1997 (Musil in Dobešová et al. 2003).

In the beginning of 1997, decelerated economic growth led to a slump in budget revenues, which resulted in a 14.4 billion CZK deficit in April. Had the public finances continued in the same trend, the deficit would have risen to 50–55 billion CZK at the end of the year (Musil in Dobešová et al. 2003). The government reacted with fiscal packages that limited government expenses on investments, subsidies, and welfare, including wages in the public sector. After the currency crisis, the government adopted another package and the restriction amounted to 50 billion CZK. Such restrictive policy contributed to economic crisis (see the analysis by Bezděk and Král 2001). Once the packages were phased out, the fiscal policy was planned to be rather expansive—the 1997 deficit amounted to 15.7 billion CZK (Janáček et al. 1999).

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Nineteen ninety-five was a year of strong economic growth. Czech reformers were receiving international recognition. It was admitted to the Organisation for Economic Co-operation and Development (OECD) as the first among postcommunist countries.

BOX 23 Real exchange rate

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The real exchange rate expresses the ratio between foreign prices and domestic prices, measured in the same currency. For example, the real exchange rate between the CZK and the euro (in direct quotation) is as follows:

$$E_r = \frac{E \times PF}{P}$$

where E_r is the real exchange rate; E —nominal exchange rate (crowns per euro); PF —foreign price level in euros; P —domestic price level in crowns. The fraction numerator is the conversion of foreign price level to the CZK. The real exchange rate and its changes express the competitiveness of domestic products against foreign products. If $E_r = 1$, it is identical; $E_r > 1$ higher and $E_r < 1$ lower (Hindls, Holman, and Hronová 2003).

The theory of real exchange rate found much practical application in economic transformation process. From 1990 until May 1997, the Czech Republic used a fixed nominal exchange rate, with oscillations within the

fluctuation band, and the greatest influence on the real exchange rate was exerted by price level changes. If we consider relative price changes between the Czech Republic and its main trading partner—Germany—then it is clear that the price level in the Czech Republic grew much faster. In the formula, the denominator grew faster than the numerator and domestic products were losing relative competitiveness.

I may illustrate this phenomenon with the following simplified example. A Czech company sells its product to the German market for 100 marks. The exchange rate is 1:20, so the company gets 2,000 crowns. Suppose that the product costs are 1,000 crowns and so the profit is 1,000 CZK. In the long run, however, the price level rises (10 percent growth), while the German level remains stable. The product still sells for 100 marks and the exporter gets 2,000 CZK thanks to the fixed rate. However, his expenses increased by 10 percent to 1,100 CZK owing to the domestic price level increase and therefore his profit decreases—this is the aforementioned loss of competitiveness due to the appreciation of the real exchange rate.

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The growth was so high that it provoked a discussion on economic overheating, which, however, did not manifest itself in the acceleration of price level growth, but did in the increased trade imbalance (Holman 2000). The appreciation of the real exchange rate of the crown also contributed to this imbalance.⁴¹

BOX 24 Dispute about the liberalization of the financial account

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The liberalization of capital movements turned out to be a controversial measure. Liberalization should lead to better allocation of resources—the capital moves from countries with capital surplus to countries with capital deficiencies. In theory, lifting barriers for capital movements should bring about the inflow of capital, better investment opportunities, and early catching up with advanced countries. Alternatively, opening the financial account can be problematic in a country with a fragile banking sector. Households that do not trust domestic banks may deposit their money abroad, further threatening the stability of the domestic banks. The banks have to face the competition of foreign banks, which do not necessarily have a physical presence in the country. The liberalization of capital transfers combined with fix exchange rate is particularly dangerous, as the Czech central bank learned

the hard way. The CNB first faced problems related to the capital inflow (1994–1996) and further to its outflow during the monetary crisis in May 1997.

The rather quick achievement of external (full) convertibility by January 1, 1995 was understood as a success for the Czech transformation.⁴² It was discussed for quite a while. For example, the CNB vice governor Pavel Kysilka admitted, at the end of 1994 that the OECD demanded convertibility, but the CNB had considered it on its own before (Klvačová 1994).⁴³ Dědek mentions that the everyday practice was close to full convertibility even before October 1995 (Dědek 2000). In other words, the introduction of convertibility abolished limitations to capital movement, but it frequently just codified the already existing conditions and their practical effect was negligible. Dědek also claims that the principal discussions dealt with permitting external circulation of the crown, but this was already happening. Similarly, Myant believes that the old regime would have been difficult to preserve (Myant 2003).

Klaus subsequently criticized the pace of liberalization of the financial account. He thought the motive for this measure was the effort to lower expenses of the central bank on sterilization (e.g., Klaus 2000; see also BOX 25) and he claimed to have perceived this measure with misgivings. Earlier, however, he wrote: "The degree of transformation we reached makes it possible to continue in this deregulation process very quickly and come close to the standard level of the so-called full convertibility, as defined by the IMF, very soon. This is our clearly defined goal" (Klaus 1994).

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The admission to the OECD was accompanied by the introduction of external convertibility of the crown in October 1995 (see BOX 24).⁴⁴ It further contributed to the inflow of foreign capital and thus limited the autonomy of the CNB. The central bank managed to keep the price growth on the lowest level of all transforming countries, but the rate around 10 percent appeared to be firmly anchored in inflation expectations of all market subjects.⁴⁵ The central bank had limited abilities to change it. If the central bank raised interest rates, the measure would manifest itself in the inflow of foreign capital (due to a higher interest rate differential), which would then influence the growth of the monetary base and result in price growth. But decreasing interest rates (as a measure aiming to make the domestic environment less attractive for foreign investors) is in essence a demonstration of expansive monetary policy with "direct" price consequences. Besides, it would lead to a reduction in savings and pressure on the inflow of foreign capital from the

demand side—this problem is sometimes referred to as Tošovský's dilemma (Lipschitz, Lane, and Mourmouras 2000). The decisions the central bank had to take were difficult and the bank had to use less effective instruments, such as sterilization measures (see BOX 25).

BOX 25 Sterilization measures

The inflow of foreign capital caused problems for the central bank and threatened the stability of the monetary system. In the fixed exchange rate regime, the central bank was forced to apply the so-called intervention automaton, obliging the CNB to buy all foreign currency offered by commercial banks at the given fix rate (Dědek 2000). The crowns that the bank issued into circulation in exchange for the foreign currency were then fully or partially sterilized using treasury bills (i.e., selling of securities) by the central bank. Their goal was to limit pressure on the monetary base and thus on price growth. According to Myant, the systematic sterilization effort began in the second quarter of 1993, but the main era of this policy came in 1994 and particularly in 1995 (Myant 2003).

Sterilization measures contributed to the increase in foreign currency reserves in the economy—from nearly zero in 1993 to 14 billion dollars in 1995 (the 1995 increase alone amounted to 7.5 billion; see Dědek 2000). The volume of the CNB treasury bills held by commercial banks grew concurrently. Kubiček writes that between January 1994 and February 1996 this volume increased from 28.6 billion to 115 billion CZK (Kubiček 2002). However, the sterilization operations were quite expensive since the central bank received lower interest rates on foreign currency assets than the interest rates it was forced to pay on crown liabilities. In addition, the CNB had to encourage commercial banks to hold high volumes of treasury bills in their portfolio by increasing interest rates, which in turn increased the interest rate differential and attracted even more foreign capital. To measure success of sterilization, a compensation coefficient can be counted. It attains values between 0 and 1. If it is 1—it means that the sterilization is maximally effective because it does not cause additional inflow of foreign capital. On the contrary, value 0 means that sterilization is entirely unsuccessful because all the actives were purchased by foreign subjects. The estimations of the coefficient value varied by different authors, but they were generally relatively low and sterilization measures were thus relatively noneffective (see Table 4.9).

Table 4.9: Studies of compensation coefficient

Author of the study and year	Period	Compensation coefficient
Teja (1995)	2/1993–12/1994	0.001–0.49
Šmídová (1996)	10/1994–5/1995	0.2–0.4
Frait (1996)	12/1991–8/1995	0.45–0.65
Tomšík (1997)	1/1993–12/1996	0.52
Tomšík (1998)	1/1995–12/1996	0.72

Source: Chromec (2006).

Musil also claims that this operation forced out private investments⁴⁶ (Dobešová et al. 2003). Assessing sterilization measures is therefore a difficult task. Before sterilization, inflow of foreign capital resulted in an increasing amount of money in the economy, which was higher than planned (Janáčková 2000). It was even clearer that the central bank could not confront the inflow of foreign capital even with sterilization measures, and therefore decided to widen the fluctuation band of the crown in February 1996.

The budget was still nominally in surplus, but the problems I mentioned in the previous chapter remained—that is, the structural deficit was growing. The government kept lowering the tax burden, but it was not particularly successful in cutting expenses, especially on welfare. Holman observes that no government in postsocialist countries managed to find support for lowering welfare expenses on the level that corresponded to their economic productivity (Holman 2000). He therefore speaks of premature welfare states.

Nineteen ninety-six was election year, which proved to be essential for future developments. As I have already mentioned, the position of the coalition was weak, partly due to tensions among coalition partners. Economic growth continued, although slower than during the previous year, but the inherent problems and imbalances were deepening.

BOX 26 Decline in reform efforts:

The reform process remains unfinished

Criticism of Klaus's governments for backing away from reforms accompanied his entire era. As time went on, and especially after the 1997 monetary crisis, some economists started to criticize the reform process for remaining undone. They blamed the ODS for the deceleration; claimed that it should have

happened after the end of voucher privatization in the so-called evolutionary phase of economic development;⁴⁷ and pointed to the weak support of the transformation process within the coalition (see Dillon and Wykoff 2002; Sommer and Tůma 1999; Schwarz 1998, respectively). The latter fact might have aggravated the previous conflict between words and reality. In 2000, Klaus himself pointed out that the government coalition's weakness after the 1996 elections limited the strength of the government (Klaus 2000).

While judging the government policy in this era, several aspects must be taken into account—the natural effort of the politicians to stay in power; exhaustion from the transformation; strengthening interest groups and limitations of the proportional representation system. As for the first consideration, it is obvious that even right-wing politicians were looking for ways to stay in power in spite of the rather drastic reform. Perhaps I might formulate their effort as an endeavor to preserve support for the reform process.⁴⁸ I concur with Sojka that the resulting policy was simply “pragmatic” (Sojka 2000). Direct results of this policy are visible in the following areas—bankruptcy laws, assistance to large enterprises, the Czech way, and the banking sector development. In these regards, economic policy was adjusted to preserve employment and political support for the government parties. As for the second consideration, I understand it as certain exhaustion from the reform effort. The initial tempo of the reformers was enormous (for example, Husák 1997). Tříška also mentions the exhaustion from the entire reform process (Tříška 2002). Sommer and Tůma write about the loss of motivation (Sommer and Tůma 1999). It is therefore not surprising that the tempo of reforms faded away, especially when crucial measures (e.g., liberalization) had been implemented at the beginning of the decade. The third factor relates to the theory of political capital. Public support for the reforms was indeed partially exhausted and pressure groups in politics were becoming ever stronger (trade unions, for example) and tried to decelerate the reform process in various ways. Disillusion from the market system was setting in. The fourth factor relates to the Czech electoral system, which produces coalition governments. Government coalitions before the end of 1997 could be described as right-center and unlikely to champion purely right-wing or libertarian policies, especially the fragile coalition after 1996. It is not surprising that the political parties tried to alleviate the consequences of reforms for their voters and to promote more popular policies.

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There were several imbalances in the economy. The principal problematic area was the balance of payments, specifically the trade balance and the current account balance. Deficits on these accounts were equalized by the inflow of capital (but the deficits can also be perceived as a result of such inflow). The inflow represented growing trouble for the monetary policy of the central bank. Tošovský's dilemma led to "inflation trap" and the inflation in the country was higher than in developed countries (for more on causes, see BOX 38). To maintain positive real interests, the central bank was forced to keep higher nominal interest rates. Higher interest rates generated the interest rate differential and represented an impulse for even higher inflow of (short-term) capital. The central bank, in the effort to increase risks for foreign investments, first expanded the fluctuation band of the crown from ± 0.5 percent to ± 7.5 percent (in February 1996).⁴⁹ By mid year, other measures were aimed at improving the imbalance, including restrictive measures—the repo rate was raised, the minimum reserves requirements were also raised, and the conditions of operation for banks became stricter (these measures became controversial and are discussed in BOX 36). Due to the inflow of foreign capital, the volume of financial reserves outside the defined monetary corridor was still growing (Hampl 2001). Another problem was that the monetary restriction could hardly affect the growth of nominal wages or external imbalance—that is, the areas where the economic imbalance existed in reality.⁵⁰ Jonáš, for example, claims that the fiscal restriction was a suitable measure in this situation (Jonáš 2000). But the government before a general election was not willing to push it through and after the election, it was no longer strong enough. Furthermore, government economists had different opinions than those of the central bank concerning the causes of imbalance, if they deemed them to be important at all (see BOX 41).

Some economists pointed out other transformation downsides,⁵¹ such as the problematic course of privatization, unclear property relations (linkage between banks and enterprises), insufficient legal backing, mutual debts among companies, dysfunctional capital market (actual impossibility to issue new shares), and low profitability of enterprises. They claimed that all these factors were reflected in slower restructuring, also resulting from the shortage of capital or limited managerial skills (e.g., Spěváček 2001). Frequent changes of legal norms and a shaky legal system also contributed to these issues. Other problems consisted in law enforceability (Chapter 10.3), and uncompleted liberalization and deregulation processes (see BOX 26).

4.3 1997–1999: Recession stage

In 1997, the economic problems previously hidden in the economic growth resurfaced in full light. In the spring, the economic growth slowed down, the external imbalance increased and then came the monetary crisis, which subsequently overflowed in the entire economy. Until 1999, this period was characterized by economic recession or, in better times, stagnation.

In early 1997, the economy began to slow down. The budget, however, was planned in expectations of growth and the deceleration manifested itself in cyclical deficit. The trade balance deficit remained and the economy was thus struck with the so-called twin deficit. The result was the pressure to restore the budgetary balance. In April, the government decided to adopt the so-called package of measures, under the official title “Correction of economic policy and other transformation measures.” Its aim was to improve the macroeconomic balance by restricting budgetary expenses, slowing down wage growth, and limiting foreign imports. These cuts amounted to 25.5 billion CZK. At the same time, the government strove for devaluation and milder monetary restriction (Kočárník 2000; Myant 2003). According to the CNB vice-governor, the central bank refused to devalue, arguing that any instability could cause panic on foreign exchange markets (Dědek 2000). However, Kočárník offers a different explanation: “we had a relatively quiet solution for the first saving package, but the governor would not listen—perhaps not so much for pragmatic reasons, but rather because of recently surged animosity between him and the PM. I believe that sticking to the fix exchange rate in this period was one of the gravest mistakes of the whole transformation process in the Czech Republic” (Kočárník 2000). The government only managed to persuade the central bank to slightly decrease mandatory minimum reserves.

BOX 27 Currency crisis

The course of the crisis in May 1997 is detailed in the anthology titled “Three years after the monetary crisis” (CEP 2000):

Thursday, May 15: the exchange rate plummets 5 percent under the central parity and the CNB intervenes for the first time, and the exchange rate increases to 3.4 percent in the devaluation band as a result. The CNB announces it will raise the repo rate, the exchange rate returns to 3 percent under parity, but then weakens to 3.7 percent against parity.

Friday, May 16: speculators escalate the pressure and the CNB raises the Lombard rate from 14.5 percent to 50 percent, and the crown strengthens by more than 1 percent. The minister of trade and industry Vladimír Dlouhý goes public with the opinion that, in the given situation, the government should resign and the same coalition partners should form a new government.

Monday, May 19: the CNB raises the repo rate to 45 percent and intervenes to withdraw more crowns from the circulation. The daily loan rate on the interbanking financial market increases to 38 percent, the deposit rate to 35 percent.

Tuesday, May 20: the increased interest rates partly stabilize the exchange rate. The crown slightly strengthens to 1.6 percent under central parity.

Wednesday, May 21: speculators continue their frontal attack. Interest rates on the interbanking market go up to 500 percent for a brief period of time. The crown weakens by 0.75 percent and closes at 2.6 percent in the devaluation band.

Thursday, May 22: the crown slumps 6.4 percent under the central parity. The CNB administratively cuts off foreigners from short term loans in crowns. The panic culminates. Enterprises start to speculate on the exchange rate, citizens convert crowns into foreign currency. It is estimated that the CNB loses 500 million dollars in reserves on this day alone. The CNB spokesman denies that the bank plans to devalue the crown in the days to come.

Friday, May 23: the crown hits the bottom at noon—5 percent in the devaluation band. The subsequent CNB intervention and the raising of the repo rate to 75 percent strengthens the exchange rate to 1.3 percent in the devaluation band. People queue up in bank subsidiaries, exchange offices are running out of foreign currency.

Saturday, May 24: Dlouhý announces at the ODA party convention his intention to leave the government. The minister of finance Kočárník and the interior minister Ruml resign from office.

Monday, May 26: PM Klaus and governor Tošovský announce that the CNB changed the exchange regime to floating. The prior fluctuation band is abandoned. The exchange rate closes at 2.7 percent on the former devaluation side, at 18.05 CZK/DM and 30.51 CZK/USD.

Tuesday, May 27: during the day, the crown plummets to 19.40 CZK/DM. Chairmen of coalition parties draw up a document outlining planned personal changes in the government. Additional budget cuts are under preparation.

Wednesday, May 28: the crown on the interbanking market settles down. Chairmen of coalition parties announce the new stabilization and recovery

program ("the second package"), and personal changes in the government (Ivan Filip—the newly appointed minister of finance and Karel Kühnl—the newly appointed minister of industry and trade).

Thursday, May 29: the exchange rate of the crown ends at 18.85 per DM and 32.00 per USD, returning to the border of the former fluctuation band.

The entire crisis is summed up in Table 4.10.

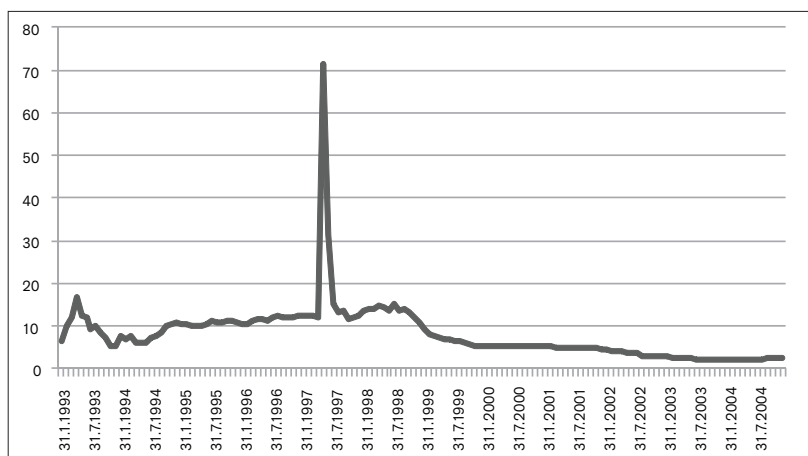
Table 4.10: Situation at the beginning and at the end of the monetary crisis

	April 30, 1997	May 30, 1997
REPO –1day	10.79 %	151.88 %
Lombard	14 %	50 %
Discount	10.5 %	13 % (no trading)
CNB foreign currency reserves	11.518 billion USD	10.025 billion of USD
Exchange rate CZK/DM	17.903	19.180
Exchange rate CZK/USD	31.005	32.691
Exchange regime	fixed exchange rate with wider fluctuation band 7.5 %	controlled floating with officially undeclared band

Source: CEP (2000).

Highly interesting was the development on the interbank market during the crises. Banks did not trust each other and the interest rate extremely increased. The development of a one-day interest rate is depicted in Figure 4.6.

Figure 4.6: One-day interest rates on the interbank market (monthly average in %)



Source: ČNB (2011).

Brada and Tomšík quote the indicators of external imbalance that are monitored by investors to make sure their investments are secure (Brada and Tomšík 2004). They prove that the indicators in the CR before the monetary crisis exceeded safe limit values (see Table 4.11).

Table 4.11: Indicators of external imbalance and their development before the monetary crisis in May 1997 (in %)

Indicator	Limit value	1994	1995	1996	1997
Gross debt/GDP	40	29	32.5	36.2	44
Current account/GDP	-5	-1.9	-2.6	-7.4	-6.1
Debt service/GDP	5	6.5	5.6	6.2	9.3
Debt service/export	20	15	12.4	10.9	15.6
Short-term debt/total debt	40	30	31	28	33
Covering of import by foreign exchange reserves (number of months)	3	4	6.2	4.4	3.9

Source: Brada (2004).

Moreover, the internal economic problems were accompanied by foreign investors' general growing mistrust of emerging markets that later on resulted in the crisis in South-East Asia. The consequence was the May attack on the fixed exchange rate of the Czech crown—both foreign and domestic subjects started to sell crowns for foreign currencies expecting devaluation.⁵² The central bank decided to defend the fixed exchange rate by selling foreign currencies and buying crowns, and by sharply increasing the interest rates. But the markets believed the exchange rate was overvalued and, eventually, the central bank was forced to abandon the fixed regime and replace it with floating. However, the subsequent postcrisis devaluation was not dramatic—about only 10 percent against the original parity (see more detailed currency crisis development in BOX 27 and details about speculation on currency in BOX 28).⁵³ The overall view of the currency crisis (causes and impacts) can be seen in scheme Diagram I at the end of the book.

BOX 28 Speculation on currency devaluation

Speculation is based on the conviction of investors that the currency in question is overvalued. Without this presumption, emerging systematic pressure on the currency is very unlikely. The term is usually accompanied by negative connotations, but I think it should rather be perceived as a rational behavior of

investors. More specifically, speculation is defined as an effort to make profit on currency devaluation. This is part of the general effort of foreign investors to leave the country and protect their assets. Speculation on currency devaluation is based on short selling. Let us consider the Czech Republic as an example. The speculator borrows crowns and exchanges them for foreign currency, thus further increasing devaluation pressures. If the devaluation really occurs, he exchanges his money back, pays interests on the loan and the difference is his profit. An investor borrows, for example, 1,000 CZK, he exchanges it on the foreign currency market at the rate of 1:20 per DM, so he gets 50 DM. Subsequently, the crown devaluates to 1:25 exchange rate. The speculator exchanges his 50 DM for 1,250 CZK. He pays his debt plus the interest, and the rest is his profit depending, of course, on the amount of devaluation and interest rates. This explains the behavior of the CNB which, in the effort to prevent or at least limit speculative behavior increased interest rates sharply—the Lombard rate to 50 percent and the median repo rate up to 164.92 percent. As a result, the rates on the interbanking market climbed up to 85.6 percent (Myant 2003). At the same time, the central bank fought the market pressure and sold foreign currency reserves. It tried to dampen devaluation pressures to make it possible for nonspeculative investors to leave the Czech market (Dědek 2000). The central bank spent 2.293 billion dollars on these operations. The Czech foreign currency reserves decreased by 14.9 percent (Myant 2003). The central bank gave up its efforts after even Czech subjects started to sell the crown massively, meaning nobody trusted the given exchange rate. The loss of foreign currency reserves was later criticized (for example by Klaus 2000).

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In reaction to the crisis, the government adopted another correction of budget policy in May and announced it as the so-called second package of measures (official name was: Stabilization and recovery program of the government coalition). It meant further restriction—frozen wages in public sector, cuts in budgetary expenses, and the so-called import deposits.⁵⁴ The cuts amounted to 16.9 billion CZK, which was approximately 7.7 percent of all planned expenses and approximately 2.5 percent of GDP (Hájek, 1997).

Throughout the year, the central bank kept gradually decreasing interest rates, but its general policy remained fairly restrictive.⁵⁵ At the end of the year, the CNB decided to change the entire monetary policy regime and to focus on inflation targeting (see BOX 29). The first net inflation target was set at 5.5–6.5 percent,⁵⁶ which was perceived as quite ambitious at the time

(HN, December 23, 1997). Economic problems contributed to turbulences on the political scene. Several ministers were replaced after the monetary crisis and, in the fall, Václav Klaus's government was removed from the office. Political representations later agreed on preliminary elections.

In the first half of 1998, the interim government with Josef Tošovský as the PM was appointed to power, with the principal task of leading the country to preliminary elections. The goal was met in June, with Social Democrats emerging as the winners. The party ran on the program of change, including economic policy. Yet the political situation and the weakness of the new government rendered it impossible to make any dramatic turns in this regard.

The country was in economic recession, especially due to the lower tempo of household expenditures and lower investments. Even large companies such as Škoda Plzeň or Chemapol faced troubles. Yet the deficit of the current account in the balance of payments was decreased. The cabinet relaxed the fiscal restriction and, in the second half of the year, raised expenses in the effort to bolster economic growth, although it was limited by the previously approved budget.⁵⁷ The budget ended with 1.5 percent of GDP deficit. In the fiscal area, income tax for legal people was lowered from 39 percent to 35 percent. The monetary policy did not support growth and the bank did not decide to decrease interest rates until the end of the year, when the two-week repo rate decreased from 12.5 to 9.5 percent in three steps. The interest rates were kept fairly high for the entire year, and the same applied to mandatory minimum reserves of banks. The fact that the central bank did not yet grasp all pitfalls of the new monetary regime—such as inflation targeting—also played its role. The CNB had troubles with forecasting, with transmission mechanism, and with delays. The planned inflation target was therefore greatly undershot (the net inflation was 1.7 percent, while the targeted band was 5.5–6.5 percent, i.e., the error margin amounted to 4.3 percent). However, the central bank was not solely responsible for this undershooting and for the price growth slump, because the global decreasing material and food prices already played its role (Hampl 2001); and the foreign demand also dropped (Tomeš 2000). Others attribute the target undershooting to the loss of autonomy in monetary policymaking (e.g., Janáčková, 2000).

BOX 29 Inflation behavior

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In December 1997, the CNB board decided (without consulting the cabinet to change the monetary policy regime) and at the start of 1998 it switched to

inflation targeting (e.g., Dědek 2004; Holman 2000).⁵⁸ This regime was first used in New Zealand in the early 1990s and soon gained wide popularity among central banks. The CNB states the following:

The principle of inflation targeting consists in the adoption and declaration of inflation targets and the implementation of necessary monetary/political measures based on inflation forecasts. The so-called conditioned inflation forecasts, modeling future developments using currently existing (unchanging) interest rates, were used first. Perfecting forecasting tools and the introduction of a comprehensive economic model made it possible to switch to the so-called unconditioned inflation forecasting, which already involves a model reaction of the central bank macroeconomic developments. (CNB 2003)⁵⁹

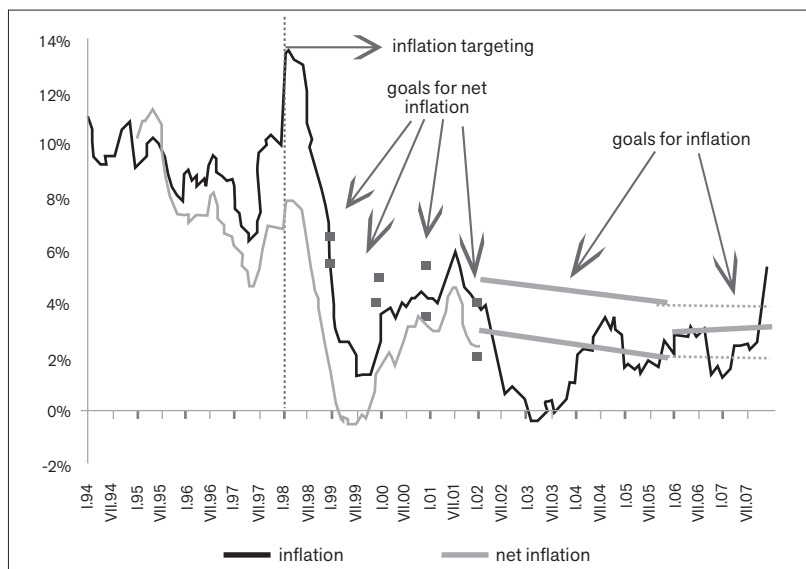
The CNB opted for alteration of its strategy when unreliability of its previous regime of monetary aggregate targeting became apparent (Janáčková 2000). Abandoning the fixed exchange rate, which anchored the entire system, also played its role (Kvizda cited in Dobešová et al. 2003). In the first stage (until 2002) the central bank targeted the net inflation aggregate, which is inflation purged of changes in regulated prices and impacts of changes in indirect taxation. The CNB claimed that the net inflation reflected inflation movements of 82 percent of the consumer basket (CNB 2003). It was used mainly due to high uncertainty concerning the intentions of the next political representation (before elections in June 1998) regarding price deregulations. Since 2002, the total inflation is targeted (i.e., the increase in the index of consumer prices). The central bank reserved a number of escape clauses in the form of exogenous factors that are completely or largely outside the purview of its monetary policy—such as major deviations in global prices of raw materials; major deviations in the exchange rate; natural disasters; step modifications of indirect taxation.

The central bank sets its targets in time horizons—short-term, midterm, and long-term. For example, short-term net inflation target for the year 1998 was between 5.5 and 6.5 percent. As I have mentioned, the central bank almost never succeeds in meeting its short-term goals (Figure 4.7); for example, the 1998 net inflation was only 1.7 percent. Said the CNB vice-governor Dědek:

The same magical power that did not allow mythical Argonauts to escape the magic of the Emerald Mountain, no matter how hard they rowed, seemed to be hidden in our year-to-year targets endowed with the ability to attract short-term inflation forecasts,

regardless of the inclination of the actual inflation to wander in totally different directions. (Dědek 2004)

Figure 4.7: Inflation and inflation targets, 1994–2007 (in %)



Source: Antal, Hlaváček, and Holub (2008).

The CNB usually explains its failure to meet its targets because of external factors, such as declining global prices of raw materials and food, abandoning price deregulations (CNB 2003; Dědek 2000a, 2004). The bank also argues that it meets its midterm goals (e.g., Dědek 2004). Myant quotes several other reasons why the set targets could not be met—limited effectiveness of monetary policy instruments; low impact of monetary instruments compared to fiscal instruments; high impact of price deregulation; and mutually conflicting targets of the central bank (Myant 2003); and I could probably add the limited knowledge of the transmission mechanism. The impact of external factors led some economists to claim that inflation targeting in an open economy is nothing but an illusion (e.g., Janáčková 2000).

Although I have sympathy for the troubles monetary policy faces in a small, open economy, I must admit that I find the systematic undershooting of inflation targets rather problematic. If the central bank finds it difficult to meet

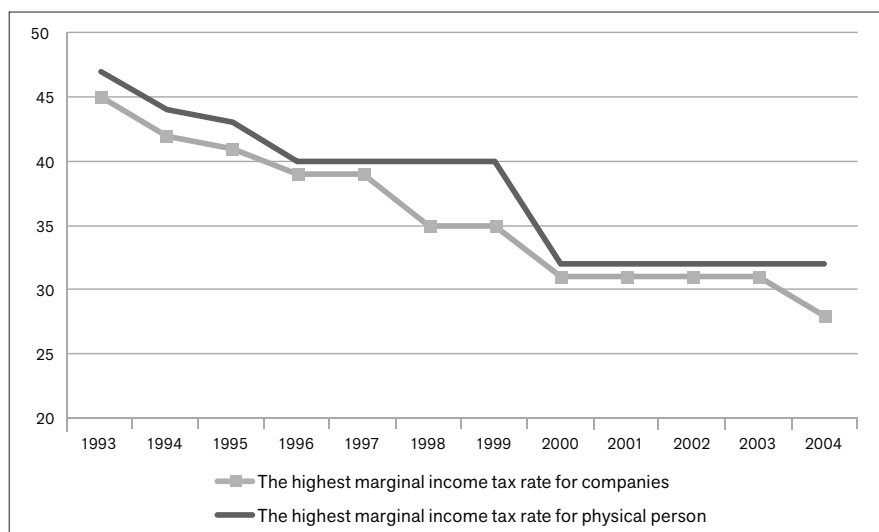
its inflation targets, it should sometimes undershoot and sometimes overshoot. Yet, in the respective period, it never overshoot and therefore I believe that there must be some problem on the side of the CNB, or that the central bank shows a permanent bias toward lower inflation than it plans.⁶⁰ If one of the goals of inflation targeting is to set expectations in the economy, then undershooting negatively influences market subjects and undermines confidence in the activity of the central bank. Myant mentions that in Great Britain, systematic undershooting is perceived just as negatively as overshooting, probably because of the possible relation between inflation and economic growth (Myant 2003). The issue of target meeting is closely related to the zero responsibility of the central bank, compared to, for example, the full personal responsibility of the governor in New Zealand (see BOX 31 on the independence of the CNB).

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During 1998, the institutional environment in the country was changing. Tošovský's government raised regulated prices of electricity by 24 percent, gas by 27 percent, and rents by 27 percent. The Securities Commission started to work too. The so-called minor and major amendments to the Law on Banks were passed. These amendments attempted to solve the current problems in the functioning of the banking sector, as well as limited personal relations between banking and nonbanking subjects and tightened insider trading rules. Privatization of large banks started with the sale of Investiční a poštovní banka (IPB). Bankruptcy laws became stricter. Stock exchange functioning was also modified—trading in the SPAD (Market for shares and bonds supporting system) segment was launched.

Politically, 1999 was fairly calm—the social democratic cabinet governed with the quiet support of the ODS, but it was weak; for example, the budget was not passed until mid-January.⁶¹ Fiscal and monetary policies continued along with previous trends. The fiscal policy was quite expansive; taxes were lowered and the government canceled the highest band in the physical persons income tax. It generally meant that the previous year's trend continued, as shown in Figure 4.8. It is not a surprising consequence that the budget deficit grew hand in hand with the effort of the government to boost the economy.⁶² For general discussion about government's economic policy in this period see BOX 30.

Figure 4.8: Tax rates, 1993–2004



Source:

In May, the government passed the National Employment Plan, which was supposed to lower unemployment by increasing the share of active policy on the labor market, support the creation of new jobs, change employees' motivation, and so on. (Musil, Dobešová et al. 2003). The CNB was decreasing interest rates throughout the year—the repo rate decreased from 9.5 percent to 5.25 percent at the end of the year. In October, the central bank lowered minimum reserves to 2 percent, to put it in line with the EU requirements.⁶³ Nevertheless, the bank undershot its short-term inflation target again. It was set between 3.5 and 5.5 percent, while the real value at the end of the year was 1.5 percent. The slump in inflation rate was massive—at the beginning of 1998, the year-to-year price increase was 10.7 percent, while at the end of 1999 it amounted to just 2.1 percent. Monetary policy was thus most likely generally restrictive, which was reflected in the lower total volume of loans. The drop was also caused by the situation of banks, which became aware of the large amount of classified loans (29 percent) they had provided, and were not willing to award easy loans any more. Besides, another bank got into trouble—Moravia Bank—and, in the second half of the year, three of the largest credit unions met the same fate. The situation on the banking market was also influenced by the sale of the Československá obchodní banka (ČSOB).

BOX 30 Economic policy of the social democratic cabinet

In one of our previous case studies, I discussed the discrepancy between the rhetoric and practice of the center-right governments, and the same applies to the policy of the social democratic government after 1998. The election victory of the ČSSD was accompanied by certain misgivings about the fate of transformation. Before the elections, they talked about halting privatization, increasing welfare expenses, or ending subsidies for banks (see Myant 2003). However, Miloš Zeman's cabinet privatized large enterprises, purging banks of substantial amounts of money before privatization. The government also continued the policy of lowering the tax burden for legal entities. Fears of transformation process reversal were not realized; on the contrary, the social democratic government managed to complete some measures that the previous right-wing governments were unable to finish. However, some other steps taken by the new government did not fully meet the expectations. For example, the government launched the ambitious Revitalization Program aimed to help large Czech enterprises, resulting in soaring deficit, that was even deepened by the following government. Furthermore, the government tried to improve the institutional environment in the country. Zeman promised a legislation storm, and the government started its anticorruption campaign "clean hands" and prepared The Government Fight Program against Corruption.

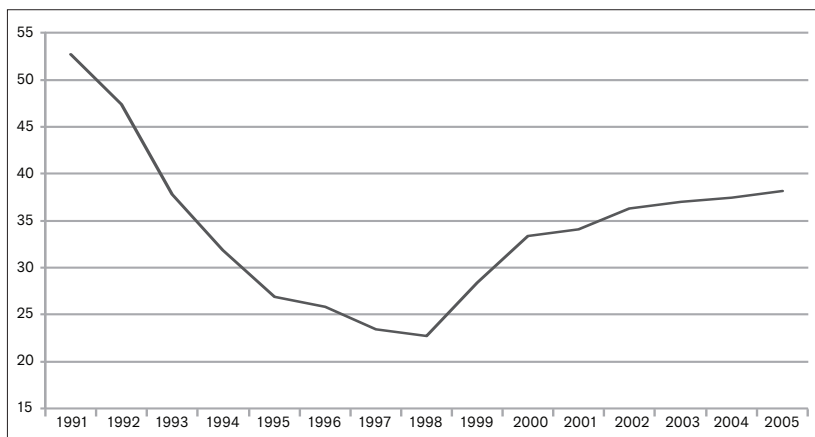
The social democratic governments increased some of the social spendings or settings in the economy that they deemed important; for example, they increased minimum wages. The previous governments generally believed that minimum wage eliminated some people from the labor market and kept it low. On the contrary, Social Democrats believed that low minimum wages motivate people to ask the state for welfare benefits instead of seeking jobs. The development of the minimum wages is shown in Table 4.12.

Table 4.12: The development of minimum wages in the Czech Republic (in CZK)

1991	1992–1995	1998	2000	2002	2005
2,000	2,200	2,650	4,500	5,700	7,185

The increase in the minimum wages appeared in the share of the minimum wages to average wages. Social Democrats wanted to increase this proportion and they were successful, as we can see in the following chart. The share started to increase in 1998 after a sharp slump that had lasted since the beginning of the transformation process (see Figure 4.9).

Figure 4.9: Share of minimum wages to average wages in the Czech economy, 1991–2005 (in %)



Source: Tvrdoh (2006).

Based on the facts above, I may conclude that if I label the policy of the previous governments as a liberal-social mix, then the policy of the ČSSD governments can safely be labeled a social-liberal mix. Both ČSSD's governments were weak as well, while the first government had the minority and the other had only the slightest majority of 101 MPs.

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The Miloš Zeman's cabinet was a much stronger supporter of active industrial policy than the previous center-right governments (see BOX 55). It drew up and approved the Revitalization Program for the Czech Industry⁶⁴ and established the Revitalization Agency in May. Eight large companies were planned to participate in the Revitalization Program—Tatra Kopřivnice, ZPS Zlín, Aliachem, ČKD Praha Holding, Škoda Plzeň, Vítkovice, Spolana, and Zetor. The total aid planned for the group exceeded 7 billion CZK.⁶⁵ In addition to this program, the government also resorted to numerous other non-standard and nonsystematic interventions in the form of financial boosts for selected enterprises, for example Vítkovice or Škoda Plzeň (*HN 2000 Yearbook* 2000). The cabinet—contrary to its previous promises—also decided to help the banks (Česká Spořitelna and Komerční Banka) one more time.

In 2000, the recovery was in full swing and the economy grew strong. The country's international reputation was boosted by the fact that it was awarded

the right to organize the fifty-fifth IMF and the World Bank Annual Conference Group.

The fiscal policy was expansive. The 2000 budget was not approved before March and so the government had to operate with the right of provisional expenditure for a long time. The approved deficit was supposed to amount to 35 billion CZK, but the result was 4 billion worse (nearly 40 billion), principally due to lower than expected revenues, although expenditures slightly decreased (*HN 2001 Yearbook* 2001). As a result, the state debt grew both in absolute terms and as a GDP percentage.

The monetary policy was stable. Principal interest rates remained unchanged in 2000, yet the total volume of awarded loans decreased. The central bank once again slightly undershot the planned inflation corridor, by 3.5–5 percent. Zdeněk Tůma was appointed its new governor.

The newly elected government promised the “legislation storm” and, indeed, numerous new laws were passed in 2000. The amended laws included the Bankruptcy Law, with the aim to make the whole process faster and cheaper, and to strengthen the position of the creditor. The Commercial Code, the Trade Law, and the Securities Act were also amended. Special attention was devoted to the Czech National Bank Act amendment. The main task of the central bank was changed from monetary stability to price stability. The procedure of appointing the bank board members was also modified and the central bank was assigned to consult its policy with the government. The amendment was pushed mainly by the ODS, which blamed the bank for the economic recession. The proposal was vetoed by the Senate and by the president, but it was eventually passed in December 2000 but later on (in 2001) was overturned by the Constitutional Court (see BOX 31). During the year the government sold another large bank—Česká spořitelna.

BOX 31 Dispute concerning the independence of the central bank

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The fundamental factor in monetary policymaking was the fact that the central bank was formed and perceived as an independent institution.⁶⁶ However, it had no responsibility toward elected subjects (Myant 2003). Several politicians-economists were also convinced that the central bank was too independent and that it had zero responsibility (e.g., Dyba 2000). The relationship between the governor and the PM were far from perfect, and it was reflected in the difficult coordination between the central bank and the government (Kočárník 2000).

The poor collaboration between the two institutions is mentioned for example by Kvizda (Dobešová et al. 2003). Klaus complained that crucial monetary policy measures were introduced without consulting the government, such as the monetary restriction in mid-1996 (Klaus 2000).⁶⁷ Yet the central bank paid attention to the fact that the government was unable to enforce recovery measures (Dědek 2000). Criticism of the central bank policy escalated after 1997 (or rather after the monetary restriction in the previous year) and after the introduction of inflation targeting and subsequent systematic undershooting of the inflation target. Klaus judged the CNB policy as too ambitious (Klaus 2004). The central bank was practically unwilling to admit any responsibility for the monetary development (see, e.g., CNB 2003; Dědek 2000, 2004).⁶⁸ Politicians—namely those from the ODS, who blamed the CNB for most of the economic problems and the resulting fall of their cabinet—endeavored to change the status of the bank through their 1999 agreement with the ČSSD. Attacks on the central bank (for example Klaus 2000b) led the CNB to media response—the CNB spokesman never admitted any responsibility for previous developments and only pointed out institutional defects left over by Klaus's governments (Tománek 2000).

The disputes took place during controversies about the CNB Act amendment in 2000. The ODS called for stronger responsibility of the central bank. The final proposal was a reasonable compromise between responsibility and independence (Myant 2003). The law was similar to analogous laws in advanced countries, but many politicians and economists perceived it as an attack on the independence of the CNB in the political atmosphere of the time.⁶⁹

The law was first passed by the Chamber of Deputies, but refused by the Senate. The veto was overruled by the Chamber of Deputies, but President Havel refused to sign it. In December 2000, the Chamber of Deputies overruled the president's veto. The amendment included:

- Members of the Bank Board are appointed by the president on the government's recommendation.
- The CNB budget for standard operations and investments is approved by the parliament.
- The highest salaries in the central bank are adjusted to the level of normal public officers.
- The "currency stability" target is changed to the "price stability," without mentioning the exchange rate.
- The central bank must consult inflation targets and exchange rate modifications with the government.

The president filed an appeal against the new law with the Constitutional Court, and the Court ruled in his favor in 2001. Almost all passages of the law were annulled, except the change of the main target of the central bank, but the custom of consulting inflation goals with the government continued regardless.

I believe it is a mistake that the central bank has practically no responsibility for the results it achieves. For example, in New Zealand—where the inflation targeting was first put into practice—the target is set after consultation between the minister of finances and the central bank governor. The latter is personally responsible that the goal is met and he can be dismissed if it is not (McCallum 1996). It should be clear now that I have sympathy for the problems of the central bank with monetary policy in times of transformation, especially during massive capital transfers. Yet, I am convinced that the central bank should acknowledge its part of the blame for the duration and depth of the crisis after 1997 and for its inflation targets' systematic undershooting (see BOX 29).

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In 2001, the budget ended with the deficit of 67.7 billion CZK, corresponding to approximately 3.3 percent of GDP.⁷⁰ Without net loans, the balance of public budgets amounted to –7.5 percent of GDP, while the revenues from privatization were 4.6 percent of GDP (*HN 2002 Yearbook* 2002). The *Yearbook* authors perceive this policy as careful, with clear effort at Keynesian approach to economic recovery. On the contrary, Janáček and Zamrazilová (2002) wrote about chronic tendency to deficits, claiming there was a trouble in the structural component of the budget, because the accelerated economic growth did not lead to the deficit decrease, but rather to its further increase (Janáček and Zamrazilová 2002)—see BOX 32.

BOX 32 Fiscal policy of the Social Democratic Party

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The Social Democrats took over the economy during the recession. Their fiscal policy was based on Keynesian assumptions and the fiscal expansion they used as a tool in solving the economic situation was therefore not surprising.⁷¹ Such policy can be substantiated in times of recession. Yet Zeman's government continued to pursue the expansion even after the recession turned into recovery—the budget deficits grew from 1.4 percent GDP in 1998 to 5.0 percent in 2003. The ratio of the state debt to the GDP grew as well. The results of public finances in general were even worse (see Table 4.13).

Table 4.13: Public sector, 1996–2004 (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
PS balance including net loans *	-0.3	-1.1	-1.4	-0.5	-2.9	-2.1	-0.5	-5.0	-3.3
PS balance without net loans and subsidies to transforming institutions **	-0.9	-1.3	-1.3	-2.2	-3.1	-2.4	-3.7	-3.8	-2.8
Cyclic component	0.9	0.2	-0.4	-0.5	-0.1	0.0	-0.2	-0.2	0.0
Consolidated debt PS	12.4	12.2	12.2	13.5	15.5	17.5	18.4	21.6	24.0
Consolidated tax quota ***	34.4	34.2	33.3	33.7	33.5	33.8	34.5	35.0	35.0

*The balance includes several revenues and expenses related only to the change in the structure of financial assets. Financial assets represent financial property (shares, property securities, obligations, and other securities), claims, and money.

**This is the total balance purged of financial operations (e.g., awarded loans or payments on previously awarded loans and operations related to purchasing and sales of financial property, and revenues from privatization) and subsidies to the so-called transformation institutions, payment of the losses of the Czech Consolidation Agency/Consolidation Bank from the state budget, and the FNM subsidies to the ČKA/KoB group and the Česká Inkasní.

***The tax quota including social security and health insurance.

Source: Macroeconomic Forecast, June 2005, Ministerstvo Financí ČR (2005).

Reasons for this development rest in the economic situation in the initial years (economic slump), when budget revenues naturally decrease and expenses grow, including the impact of built-in stabilizers.⁷² However, the structural deficit grew even in this period (Bezděk and Král 2001) and the fiscal policy was becoming ever more expansive. This development had several other causes—the high debts of transformation institutions, the costs of banking sector recovering, and the revitalization of industry. One of the estimations of the hidden deficits from the 1990s is depicted in Table 4.14. The social democratic governments therefore claimed that the previous right-wing governments were responsible for the high deficits of public finances—a problem I have already discussed (see BOX 22).

Table 4.14: "Real" fiscal deficit in the Czech Republic, 1993–1998 (as % of GDP)

	1993	1994	1995	1996	1997	1998
Official deficit	-0.5	-1.3	0.3	0.5	1.1	2.1
Hidden fiscal deficit in special institutions (KoB, ČI, ČF, a FNM)	3.2	1.9	1.0	0.5	1.0	2.0
Hidden fiscal deficit in guarantees	0	0	0.1	1.0	3.1	1.5
Real fiscal deficit	2.7	0.6	1.4	2.0	5.2	5.6

Source: Ministerstvo Financí ČR (2005).

To the government's credit, the cabinet passed the Law on Budget Rules in 2000, based on the IMF code on fiscal transparency. The new law forces the government to include the deficits of transformation institutions into the public budgets and make the national accounting more transparent. Despite the growing structural deficit, the fiscal policy of Zeman's cabinet remained quite conservative compared to the following social democratic government, which raised the deficit of public budgets according to the rules of the Maastricht criteria to 11.7 percent of GDP (see Table 4.15).

Table 4.15: Government deficit and government debt according to Maastricht criteria (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Balance	-3.1	-2.4	-5.0	-3.6	-3.7	-5.9	-6.8	-11.7	-3.0
Debt*	-	-	-	-	-	27.2	30.7	38.3	37.4

*Revised data on the government debt before 2000 are not available

Source: Macroeconomic Forecast, June 2005, Ministerstvo Financí ČR (2005).

All the governments had to face a high level of mandatory expenses in their overall expenditures. Mandatory expenses are such that the government must pay by law; for example, pensions. The higher mandatory expenses are, the less funding is there left for the government to carry out its independent fiscal policy. One of the estimations of mandatory expenses is shown in Table 4.16.

Table 4.16: Mandatory and quasi-mandatory expenses as share of government expenditures, 1995–2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Mandatory expenses	44.8	47.6	50.8	52.9	52.1	53.1	53.5	55.7	52.7	52.5
Quasi-mandatory expenses	23.0	23.4	22.6	22.2	22.6	22.3	26.6	27.9	23.5	22.3
The sum of previous	67.8	71.0	73.4	75.1	74.7	75.4	80.1	83.5	76.2	74.8

Source: Bachanova (2007).

Certain factors, namely the debts of transformation institutions, certainly played some role in this deficit. High share of mandatory expenses, limiting the government's ability to control fiscal policy, was also significant. Yet huge

deficits in times of economic growth attest to the inability of the government to deal with budgetary issues and wasteful behavior of left-wing governments.

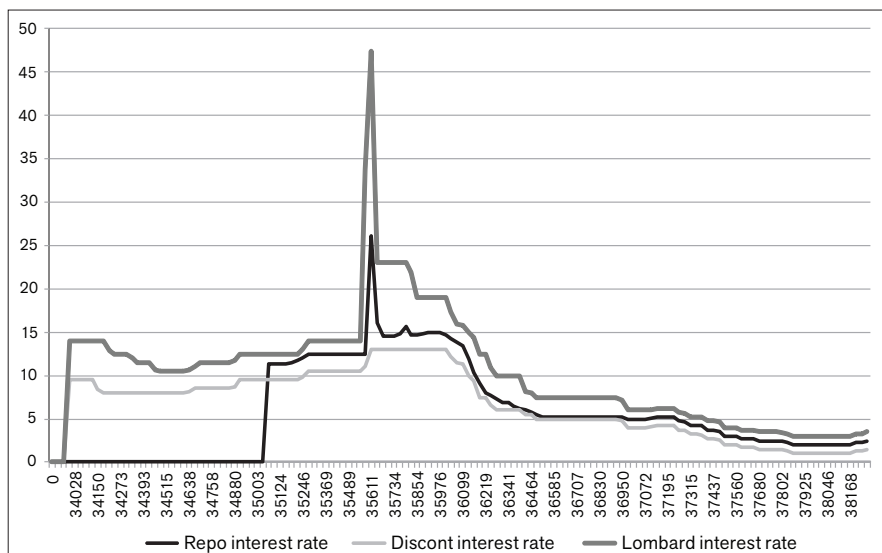
The repo rate remained unchanged from the end of 1999 until February 2001. In February, the central bank lowered the rate by 0.25 percent, only to carry out the reverse operation in July. It was not until November that the bank resolved to decrease the rates by 0.5 percent to 4.75 percent. The monetary policy had to face a fairly rapid appreciation of the crown against the euro—by 4.2 percent, and the concurrent appreciation against the dollar. As a result, the central bank was criticized by exporters. However, the CNB's power to influence this development was minimal—the bank decreased the repo rate and intervened on the foreign currency market, but it did not lead to depreciation (Janáček and Zamrazilová 2002). Besides, the central bank finally met its goal and hit the target inflation interval.

The government continued the privatization of major enterprises—it sold Tatra Kopřivnice, Jan Becher, and Transgas. An important event was the annulling of principal sections of the CNB Law by the Constitutional Court in the middle of the year. Fiscal transparency efforts also gained momentum this year, Consolidation Bank was transformed to Czech Consolidation Agency (see BOX 51).

In 2002, public budgets ended up 45.7 billion CZK in deficit, indicating that the approved budget was followed.⁷³ In August, the country was hit by floods and, from this standpoint, the actual deficit was a success. However, the *HN 2003 Yearbook* quotes the statistics of the growth of public debt against the GDP, and this index almost doubled in three years—from 13.8 percent in 1999 to 14.5 percent in 2000, 17.7 percent in 2001, and 26.0 percent in 2002 (*HN 2003 Yearbook* 2003). Janáček and Zamrazilová add that the volume of expenses on active employment policy decreased while the amount of unemployment benefits increased, which is in sharp contrast with the earlier promises of the government (Janáček and Zamrazilová 2003).

Disinflation pressures in the economy prevailed. The central bank reacted by lowering interest rates in January, April, July (by 0.75 percent), and in October. The declining trend in the central bank interest rates is shown in Figure 4.10.

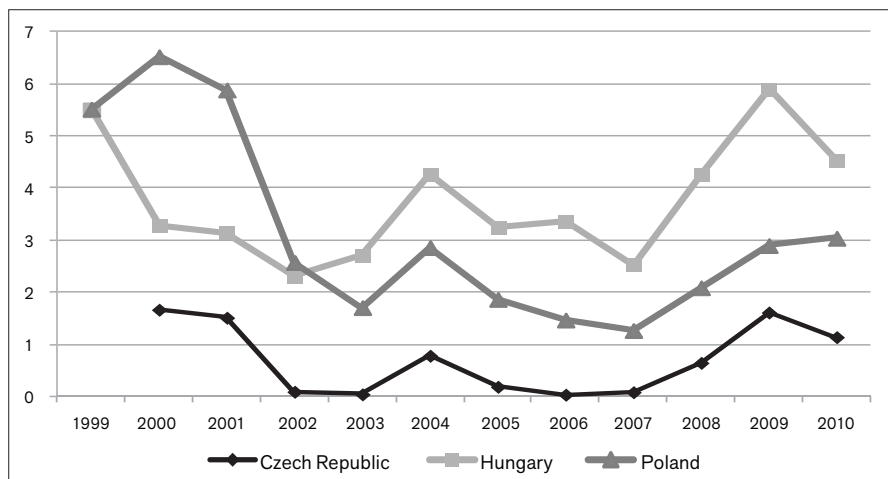
Figure 4.10: Development of the central bank interest rates, 1993–2004 (in %)



Source: ČNB (2011).

The repo rate in October 2002 was at its record low level (2.75 percent), even lower than the rate of the European Central Bank at the time, and the positive interest rate differential, which had existed during the entire transformation period, disappeared (see Figure 4.11). Still, inflation at the end of the year was also at its record low level, under the target corridor again. The price growth was approximately 3 percent below the level predicted by most analysts (Janáček and Zamrazilová 2003). This development was partly caused by cheaper raw materials—its share in the consumer basket is 20 percent and its price at the end of the year was 4.5 percent lower than in December 2001 (Janáček and Zamrazilová 2003). The monetary reserve in 2002 increased only by 6.5 percent, compared to the 12 percent in the previous year (*HN 2003 Yearbook* 2003).⁷⁴ The appreciation of the crown against the euro also contributed to the moderation of price increase (the median exchange rate to the euro strengthened by 9.6 percent). The exchange rate strengthened mainly in the first half of the year, while it weakened down in the second half, and at the end of the year the crown was almost as strong as at its beginning. The central bank reacted to these developments with interventions on the foreign exchange market. (For more on the exchange rate, see BOX 33.)

Figure 4.11: Interest rate differential (to Germany) for long-term government bonds in Central European countries, 1999–2010 (in %)



Source: OECD (2012).

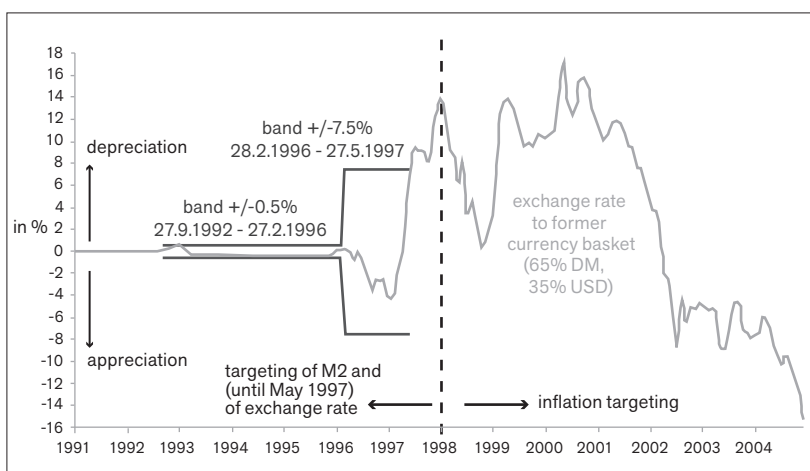
BOX 33 Nominal exchange rate

Disputes about the exchange rate were ongoing during the entire transformation. Some economists were critical of its initial setting. For example according to Pick, the initial devaluation was too high. It helped the exports of raw materials but did not help the exports of sophisticated products with higher added value where the price plays a smaller role (Pick 2000; see also Kubiček 2002; Sojka 2000).⁷⁵ Sojka argues that despite the collapse of the CMEA markets and the Gulf War, Czechoslovakia had positive trading balance in 1991 (Sojka 2000). We should not be surprised by such criticism, considering how different opinions concerning the exchange rate were presented for example by foreign advisors.

The exchange rate system itself was mired in controversy. Klaus writes that the fixed exchange rate was imposed on him—when he was the minister of finance—by the International Monetary Fund in 1990, although he himself was “very apprehensive” of it (Klaus 2000a). Nevertheless, the fixed exchange rate contributed to the economic stabilization in the initial phase of the transformation (Jonáš 1998; Kubiček 2002).⁷⁶ And its setting constituted the cushion I have discussed before.

What was the subsequent development? Myant states that the central bank wanted to reevaluate the currency as early as 1994, but Prime Minister Klaus was strongly against it (Myant 2003). The same applied for the effort of the central bank to widen the fluctuation band to ± 2 percent in the same year. The reason why inflation did not decline at the time was the growth of monetary aggregates due to the balance of payments surplus, which was caused by the unwillingness of the center to reevaluate the currency (Sommer 1995). The CNB vice-governor Kysilka mentioned in an 1995 interview that some people called for devaluation due to the trade balance deficit, while he preferred the widening fluctuation band (Mandel 1995).

Figure 4.12: Development of the exchange rate, 1993–2004



Source: Frait (2005).

In 1995, the crown became externally convertible and according to Holman it was a mistake to stick to the fixed exchange rate after the liberalization (Holman 2001). In 1996, the fluctuation band was widened in reaction to the intensive inflow of foreign capital.⁷⁷ Hrnčíř says that keeping the fixed exchange rate for so long (sixty-two months) was unique in the context of transformation (Hrnčíř 1996). The central bank stuck to the fixed exchange rate even though the government economists repeatedly asked the governor to switch to the floating rate or to devalue (Klaus 2000a; Kočárník 2000). Nevertheless, the liberalized exchange rate kept gaining strength and it did not hit its peak until February 1997 (see Figure 4.12). Imbalances in the econ-

omy led to a currency crisis (see BOX 27), but the resulting devaluation was not as dramatic as for example in Southeast Asia (see, for example, Lacina and Židek 2004). Kubiček speaks in this context only about turbulence (not a crisis) and Mach claims that this was a crisis of the exchange regime rather than of the exchange rate itself (Kubiček 2002; Mach 2000).⁷⁸ Klaus, although he previously criticized the rigid adherence to the fixed rate, admits:

We should have abandoned the fixed exchange rate earlier, at least formally. But I am not convinced whether this measure would lead to earlier and smoother decline of the exchange rate compared to what happened in the spring of 1997. I am afraid that the mood change on the market would have been just as strong, and the exchange rate would have undergone more or less the same development. (Klaus 2000a)

It is worth mentioning that the neighboring countries of Poland and Hungary decided to face the strengthening of real exchange rate during transformation using the crawling peg system. It consisted in regular (monthly) and planned (moderate) devaluations of the nominal exchange rate. As a consequence, the real exchange rate was more stable (see Figure 4.13). The Hungarian forint was in real terms de facto flat between 1994 and 2000; the same is true for the Polish zloty between 1996 and 2000.

The long-term fixed exchange rate was perceived as the source of Czech problems by those who advocated the crawling peg system (Frait and Kotlán 2000). Similarly Kvizda claims that the fixed exchange rate had been a destabilizing element since 1994 and the crawling peg would have been much more suitable (Kvizda 2000). On the contrary, Dědek wrote that the authors of the economic policy feared that the system change to crawling peg would strengthen inflation expectations in the economy (Dědek 2000). Besides, inflation in the CR was low and he believes the need for crown depreciation was not so strong. In Dědek's opinion, the fixed exchange rate supported stable prices, effective restructuring and suitable export structure.

Since the loosening of the exchange rate in 1997, the crown has been in the floating regime and fluctuating according to market forces. In 1998 the currency revaluated back to its precrisis level. The central bank intervened whenever it deemed necessary, but its ability to control the exchange rate was considered as limited (Janáčková, 2000). Myant notes that the CNB began to accept this fact only gradually (Myant 2003). In fact, interventions into the

exchange rate were rare and took place only in limited periods characterized by strong appreciation pressures of the nominal exchange rate. Most of them were carried out in 1998 and 2002.

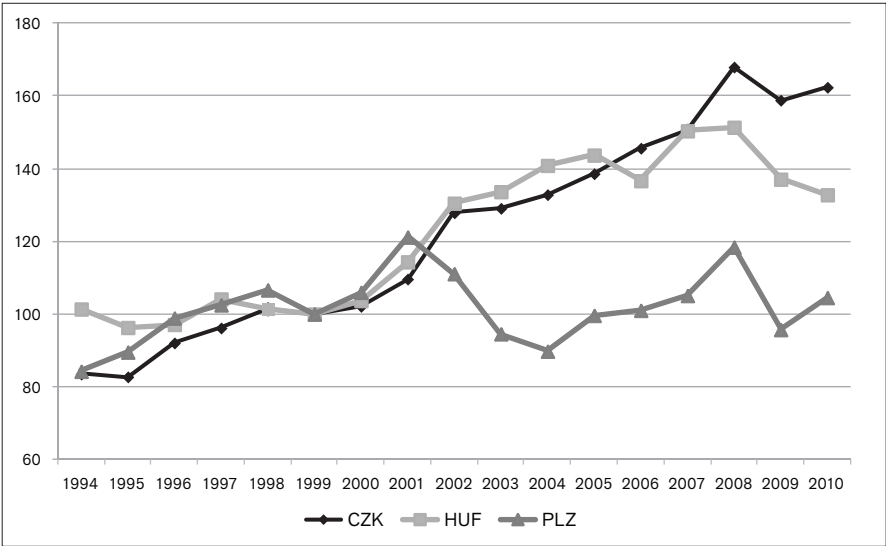
Generally speaking, the nominal exchange rate during the entire transformation was exceptionally stable. Its development since 1993 is shown in Table 4.17.

Table 4.17: Median values of nominal exchange rates against the euro and the dollar

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
CZK/EUR	-	-	-	-	-	-	36.88	35.61	34.08	30.81	31.84	31.90
CZK/USD	29.16	28.78	26.55	27.14	31.71	32.27	34.60	38.59	38.04	32.74	28.23	25.70

Source: Czech Statistical Office (2005).

Figure 4.13: Development of the real effective exchange rate in the Czech Republic, Hungary, and Poland (1999 = 100)



Source: Eurostat (2012).

In real terms the crown continuously appreciated. This is a dominant characteristic for the whole transformation period, and it lasted in the posttransformation years after the accession to the EU (see Figure 4.13). The economy had to deal with this development.

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The government made further progress in privatization and sold for example the Nová huť—LNM Holdings. The privatization of Unipetrol, which was supposed to be sold to Agrofert, was canceled. The *HN 2003 Yearbook* enumerates that at the end of 2002, thirty large enterprises designated for privatization were still owned by the state (*HN 2003 Yearbook* 2003).

The 2003 state budget was passed with the record deficit of 111.3 billion CZK. The deficit of public budgets amounted in the end to 115 billion, while the state budget itself ended with the deficit of 109 billion, corresponding to 4.5 percent of GDP. Without net loans, the deficit amounted to not fewer than 5.7 percent of GDP (*HN 2004 Yearbook* 2004). The reform of public finances was approved in June 2003. The Ministry of Finance planned to meet the euro zone convergence criteria in midterm horizon. The plan assumed lower deficit, covered partly by higher taxes (33 percent) and partly by lower expenses (33 percent)—that is lower investments and wages in the public sector (*HN 2004 Yearbook* 2004).

BOX 34 Statistical issues

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In addition to criticisms, it is necessary to adduce the argument that excuses, to a great extent, most economic policy problems. The principal decision-making factor for economic policymaking is the statistics. All decisions made by the government and the central bank are based (or at least should be based) on the statistical data. However, the economic policy in Czechoslovakia (and the CR) was confronted with the shaky knowledge of statistical quantities and the statistics often varied substantially. Table 4.18 shows the volumes of annual nominal GDP in the CR quoted from the Statistical Yearbooks of the Czech Statistical Office (ČSÚ). The yearbooks are published with a substantial delay, yet the modifications to the data are fairly dramatic—for example, the nominal GDP in 2000 increased from 1,959.5 billion to 2,150.1 billion (ČSÚ 2001, 2004). I should also add that the revisions in the table are quite negligible compared to for example alterations in estimates of quarterly tempos of economic growth, actually used in economic policymaking.

What causes this phenomenon? First, even advanced economies face similar problems, although to a lesser extent particularity. Nevertheless, the transformation sharpened these statistical problems. The ČSÚ, like other economic subjects, was not prepared for the transformation—it was not ready for the large number of newly established companies (see Table 9.4) and the

Table 4.18: Nominal GDP and growth in the CR (in billions of CZK and %)

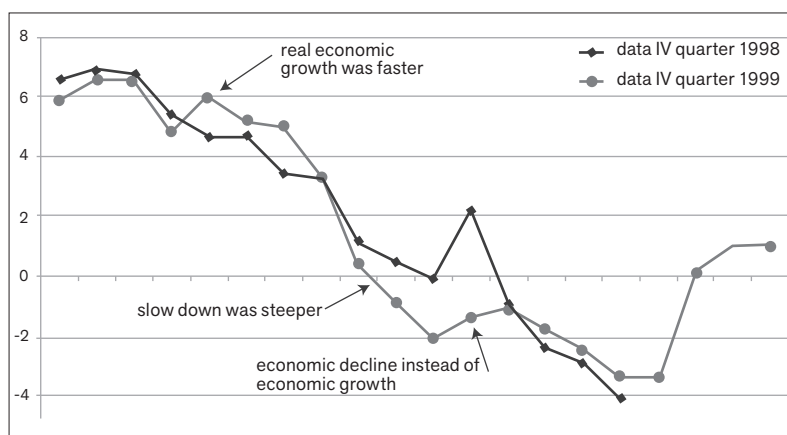
yearbook 1993–p 24–25													
no data due to federation split													
yearbook 1994–p 24–25													
90	91	92	93										
567.3	716.6	803.3	923.1										
	26.3	12.1	14.9										
yearbook 1995–p 26–27													
90	91	92	93	94									
567.3	716.6	803.3	910.6	1037.5									
	26.3	12.1	13.4	13.9									
yearbook 1996–p 26–27													
90	91	92	93	94	95								
567.3	716.6	791.0	910.6	1037.5	1212.0								
	26.3	10.4	15.1	13.9	16.8								
yearbook 1997–p 30–31													
90	91	92	93	94	95	96							
579.3	749.6	846.8	1002.3	1143.0	1338.9	1524.7							
	29.4	13.0	18.4	14.0	17.1	13.9							
yearbook 1998–p 34–35													
90	91	92	93	94	95	96	97						
579.3	749.6	846.8	1002.3	1148.6	1348.7	1532.6	1649.5						
	29.4	13.0	18.4	14.6	17.4	13.6	7.6						
yearbook 1999–p 34–35													
90	91	92	93	94	95	96	97	98					
626.2	753.8	842.6	1020.3	1182.8	1381.1	1572.3	1680.0	1820.7					
	20.4	11.8	21.1	15.9	16.8	13.8	6.8	8.4					
yearbook 2000–p 32–33													
90	91	92	93	94	95	96	97	98	99				
626.2	753.8	842.6	1020.3	1182.8	1381.0	1572.3	1668.9	1798.3	1836.3				
	20.4	11.8	21.1	15.9	16.8	13.9	6.1	7.8	2.1				
yearbook 2001–p 36–37													
90	91	92	93	94	95	96	97	98	99	2000			
626.2	753.8	842.6	1020.3	1182.8	1381.0	1567.0	1679.9	1829.4	1887.3	1959.5			
	20.4	11.8	21.1	15.9	16.8	13.5	7.2	8.9	3.2	3.8			
yearbook 2002–p 40–41													
90	91	92	93	94	95	96	97	98	99	2000	2001		
626.2	753.8	842.6	1020.3	1182.8	1381.0	1567.0	1679.9	1839.1	1902.3	1984.8	2154.8		
	20.4	11.8	21.1	15.9	16.8	13.5	7.2	9.5	3.4	4.3	8.6		
yearbook 2003–p 36–37													
90	91	92	93	94	95	96	97	98	99	2000	2001	2002	
626.2	no data	842.6	1020.3	1182.8	1381.0	1567.0	1679.9	1839.1	1902.3	1984.8	2175.2	2275.6	
			21.1	15.9	16.8	13.5	7.2	9.5	3.4	4.3	9.6	4.6	
yearbook 2004–p 36–37													
90	91	92	93	94	95	96	97	98	99	2000	2001	2002	2003
626.2	no data	no data	1020.3	1182.8	1466.7	1660.6	1785.1	1962.5	2041.4	2150.1	2315.3	2414.7	2532.4
				15.9	24.0	13.2	7.5	9.9	4.0	5.3	7.7	4.3	4.9

Source: ČSÚ Statistical Yearbooks (1994–2004).

related economic agenda. It took some time to adapt to the new situation and required permanent revisions. Moreover, the Czech data had to be harmonized with the EU statistics, which meant another large revision (Ondruš 2003), and the revisions continued. For example, in 2004, the ČSÚ chairman Jan Fischer promised a time series of comparable GDP data back to 1990, which meant another revision (Hrstková 2004).

The short-term estimations are critical for economic policy. One of the striking examples of the typical problems is the course of the 1997 economic crisis. Singer discusses how economic policy was affected by wrong estimations of economic values (Singer 1999). Initially, economic growth in 1996 was overrated and later on, economic decline in 1997 was underestimated. Economic policy would have been probably different if the economist had had more precise numbers.

Figure 4.14: Estimations of economic growth in 1998 and 1999



Source: Singer (2009).

Table 4.18 and Figure 4.14 show expost data. Forecasting data are even less successful. Bad forecasts can even be fatal, as Ivan Kočárník learned in 1997, when his bad GDP prediction practically cost him his chair of the minister of finances. Table 4.19 shows the problems encountered by statistical forecasts during the transformation. According to the last revision, the GDP in 1997 dropped by 0.7 percent, that is the original forecast of many institutions deviated by over 6 percent.

Table 4.19: Forecasts of economic growth for 1997 by various institutions in September 1996 and in April 1997

	September 1996	April 1997
Ministry of Finances	5.0	2.6
Ministry of Industry and Trade	5.5	3.5
Ministry for Local development	5.5	n.a.
Ministry of Labor and Social Affairs	n.a.	3.5
Czech National Bank	n.a.	3–4
Czech Statistical Office	5.8	n.a.
Patria Finance	5.5	4.0
IPB	5.3	4.8
Živnostenská Banka	5.5	3.1
Agrobanka	5.7	3–4
Komerční Banka	n.a.	4.5

Source: Kočárník (2000).

The CNB continued its policy of decreasing interest rates. They fell from 2.75 percent at the beginning of the year to a historic low 2 percent at the end of the year. Janáček and Zamrazilová write that the strengthening of the exchange rate had a great impact on the economic policy, and the CNB paid close attention to it and kept it in the “implicit interval” (Janáček and Zamrazilová 2004). But the M2 aggregate strengthened by 7 percent regardless, a considerable increase compared to 3.2 percent in the previous year. Nevertheless, consumer prices remained stable (the CPI [consumer price index] increased only by 0.1 percent) and thus the central bank did not meet its inflation target another time.

Privatization progressed at a relatively slow pace. The government decided to sell its share in three large enterprises—Vítkovice Holding, Škoda Holding (to Appian Group for 800 million CZK) and 37 percent of the PVT shares.

So far I have described the main measures of the economic policy during the transformation. The most difficult period involved the years 1990 and 1991, with imminent economic imbalances and numerous other tough challenges. Another challenging time came with the 1997 monetary crisis and the subsequent recession. Overall, the period was highly taxing for economic policy that had to deal with numerous problems. The reformers were able to deal with some of them better and with others worse. I personally see the

most important mistakes in hidden deficits of the central-right governments (in good times) and later on in too relaxed fiscal policy of the social democratic governments. Unfortunately, the monetary policy exaggerated its reaction to the currency crisis, thus deepening the economic crisis. But the operation of the economic policy was complicated by inaccurate statistics—see BOX 34. And foremost the reformers were able to establish a functioning market economy in the Czech Republic in a relatively short time and the economy was able to satisfy the European Union admission criteria as of 2004.

Notes

- ¹ The first meeting between the Civic Forum and the Czech economists working abroad at Koloděje castle in February 1990 was a noteworthy event. Discussion topics already involved privatization, including the voucher method (Husák 1997).
- ² One hundred percent ownership of enterprises by foreign companies was permitted this year (Myant 2003).
- ³ The amount corresponded to 5 percent of average wage at the time (Hanousek and Krkoška 1997).
- ⁴ Ježek (in Husák, 1997) wrote (hyperbolically) that Komárek proposed 5 crowns per dollar.
- ⁵ The first devaluation united the trading and nontrading exchange rate at 17 CSK/USD, and introduced the new tourist rate at 38 CSK/USD and 26CSK/DM in the effort to eliminate the black market. This undervaluation led to massive shopping by foreigners, who purchased mainly subsidized groceries which led to supply troubles and xenophobia in some areas (Jirges and Plchová 1996). In reaction, the state tightened customs checks and (in April) revaluated the tourist exchange rate by 10 percent. Twenty million foreigners visited the country in the first three months of the year.
- ⁶ Klaus claims to be the originator of the concept of transformation cushions (Klaus 1995). According to exchange rate estimates based on purchasing power parity, the exchange rate should have been between 10 and 11 CSK/USD (Jankovská 2003). Dillon and Wykoff mention that according to some economists, the crown was undervalued by 50 percent (Dillon and Wykoff 2002).
- ⁷ Exchange rates were announced at 1.00 p.m. and were valid for the next twenty-four hours.
- ⁸ Weigl mentions that the following institutions provided the financial backing: the IMF—1,313 million dollars, the World Bank—205 million, the EC Commission—248 million, and other G24 countries—89 million (Weigl 1992). In addition, the SBČS lent approximately USD 280 million on the capital market. Before the loan was awarded, discussions on the Czechoslovak reform program were in full swing. Unlike in other countries, the government presented a program that required only the fine tuning by the IMF representatives (Klaus 1991).
- ⁹ Restitution is a process of returning illegally confiscated property to its original owners.
- ¹⁰ Frait and Kotlán note that the populace accepted the drop in real wages and pensions with understanding (Frait and Kotlán 2000).
- ¹¹ On January 29, 1991, an agreement between the trade unions and the government was signed, according to which real wages should not drop by more than 12 percent

and the government pledged to increase the minimum wage against the average (Myant 2003).

- ¹² The surcharge was gradually removed after it became apparent early in 1992 that the balance of payments was not collapsing it was decreased to 10 percent and was abandoned in December, 1992.
- ¹³ The planned budget surplus for the year 1991 was of 0.8 percent GDP, with an expected GDP drop of 5 percent (Myant 2003). Klaus wrote that the goal of 8 billion surplus, agreed with the IMF, was not met (Klaus 1991).
- ¹⁴ Levčík does not say where to acquire money for such an ambitious program.
- ¹⁵ The strictness of the monetary policy is attested by Dyba and Švejnar (1997) who observe that prices in 1991 grew by 58 percent, but the M2 aggregate increased only by 27.3 percent. On the other hand, the real interest rates were negative in spite of the restriction.
- ¹⁶ Kiss writes that (strictly) orthodox policy was applied only in Russia (Kiss 1993).
- ¹⁷ Orenstein uses the wage regulation to prove that the reformers were not orthodox liberals (Orenstein 2001).
- ¹⁸ In this period, concerns about a similar development as in the former East Germany, where the wage growth exceeded work productivity resulting in the loss of competitiveness of entire branches, were strong.
- ¹⁹ The formal condition was the growth of wages in relation to the development of consumer prices. The Law passed by the Czech National Council no. 10/1993 Coll. included the government's power to define regulative and sanction measures, if the growth of nominal wages exceeded the growth of consumer prices by more than 5 percent (Polívka 1994).
- ²⁰ Citizens registered for participation in the voucher privatization since November of the previous year.
- ²¹ In 1989, the share of public expenses on the GDP was at 72.3 percent, in 1992 the index fell to 47.5 percent (Piskorzová 2003).
- ²² Nevertheless, the volume of loans for private companies grew dramatically—early in 1990, loans were nearly at zero, amounted to 71.4 billion at the end of 1991, and to 125 billion at the end of 1992 (Dyba and Švejnar 1997).
- ²³ The Slovak crown really devaluated by 10 percent in July 1993.
- ²⁴ Stamp printing was ordered in complete secrecy on July 30, 1992. The order was given to the English company Thomas De La Rue and the stamps were printed in Columbia. The delivery came in 400 boxes and its existence remained surprisingly secret (Prokop 1995).
- ²⁵ Banknotes in lower nominal values of 10, 20, 50 CSK represented 45 percent of all banknotes, but only 3 percent of money in circulation (just like coins), which is why it was not exchanged (Prokop 1995).

- ²⁶ Josef Tošovský received the Central Bank Governor of the Year award from the *Euromoney* magazine in 1993, partially for the way the currency separation was carried out (Husák 1997).
- ²⁷ Klaus strongly opposes the notion of positive development on the macro level that was achieved with weak results on the micro level. He argues that macroeconomic results are the aggregate of microeconomic results (Klaus 1995a).
- ²⁸ Secondary insolvency is a state in which the enterprise is unable to meet its obligations, because its debtors do not cover their obligations.
- ²⁹ The tax system was conceived for a way to prevent autonomous increase of the share of tax revenues on the GDP in time (Horská 2002).
- ³⁰ After its opening, the stock exchange operated only for half a day per week, and it took over a year before its business hours came close to Western standards (Fawn 2000).
- ³¹ RM-SYSTEM is a joint-stock company that organizes the securities market outside the stock exchange.
- ³² Tošovský remained in the position until November 2000.
- ³³ The fixed exchange rate was in conflict with the monetary reserves targeting since 1993 (Hampl 2001).
- ³⁴ These regulations were implemented although real wages in 1993 still amounted to only 89 percent of the pretransformation level (Jírová 2001).
- ³⁵ The new registration of citizens began the previous year.
- ³⁶ Nonmarket services remained in the state sector—education, health system, defense, public service—and selected enterprises where the state owned over 50 percent of the shares.
- ³⁷ The loan was supposed to be paid between 1996 and 1999 (Myant 2003).
- ³⁸ For more on this restriction, see BOX 17.
- ³⁹ The structural deficit is the deficit on the level of potential product. Such deficit will exist even in the situation when the economy operates on its long-term maximum sustainable level. The overall deficit consists of structural deficit and cyclical deficit (the part of the deficit caused by economic fluctuations).
- ⁴⁰ Public budgets include the state budget and extra-budgetary funds, municipal budgets and the budgets of transformation institutions.
- ⁴¹ Between 1993 and 1997, the annual revaluation of the crown was 4–7 percent (Dědek 2000).
- ⁴² The Czech measures exceeded the framework of the IMF article VIII and was close to full convertibility in reality (Jirgens and Plchová 1996).
- ⁴³ Myant writes about the pressure of domestic enterprises, which hoped for easier access to cheap foreign resources, because interest rates of domestic banks were quite high (Myant 2003).

- ⁴⁴ External convertibility removes obstacles for the movement of capital. In practice, it means liberalization of transfers on the capital account in the balance of payments according to the IMF article VIII. Greene and Isard mention that the convertibility according to the IMF article VIII means that the members must not implement—without the IMF permission—restrictions in the area of payments and transfers for the purpose of standard international transactions, except for temporary payment and transfer limits that had existed when the country became a member of the IMF (Greene and Isard 1995). Moreover, the country must not use more than one exchange rate, unless allowed by the statutes or approved by the IMF.
- ⁴⁵ For reasons why the inflation was not dropping, see BOX 38.
- ⁴⁶ The situation, in which the increase in public debt leads to displacement of private investments, is referred to as the crowding out effect. This phenomenon is caused by a limited volume of savings and increasing interest rates, with less money left for private investments and the necessity to pay higher interest rates, which leads to lower volume of private investments.
- ⁴⁷ Sommer and Tůma categorize the transformation to the revolution phase (1991–1993) and the subsequent evolution phase (Sommer and Tůma 1999). The authors claim that errors took place especially in the second phase, when coalition cabinets cast doubt on the need for further reforms (practically up to the second package). In the evolution phase, there is no direct penalty for doing nothing, compared to the revolution phase. Slower reform tempo manifests itself “only” in the drop of potential tempo of growth, not in immediate problems. Lobby pressures are often behind the slowing down of reforms, according to the authors.
- ⁴⁸ Sommer and Tůma claim that the government could have carried out numerous political measures beneficial for the economy as early as 1993 in such areas as legislation, justice, and capital markets; and the government could also privatize without fearing high unemployment (Sommer and Tůma 1999).
- ⁴⁹ The currency basket remained identical, with a 65 percent share of the German mark and a 35 percent share of the US dollar.
- ⁵⁰ In addition to the external imbalance, the wage growth also represented a problem. It was permanently higher than the price growth and the wage cushion was almost empty in 1996 (Tomeš 2000). Another aspect was that the growth of wages was faster than the growth of labor productivity (*HN 1999 Yearbook* 1999).
- ⁵¹ In reality, their voices were getting lost in the generally euphoric atmosphere and they only began to be heard during the ensuing economic recession.
- ⁵² The attack was not perpetrated solely by foreign speculators. For example in May, 40 billion crowns were exchanged to foreign currencies, of which 38 billion was changed by domestic subjects and 23 billion by domestic physical persons (Kubíček

- 2002). Kubíček thinks the monetary turbulence was caused by nonresidents, but it was escalated by residents.
- ⁵³ The exchange rate did not fall as dramatically as in Southeast Asia and the Czech Republic did not have to ask for official help abroad. The exchange rate of the crown in June was only 3.8 percent lower against the mark and 16.2 percent lower against the dollar than the previous year (Hájek 1997).
- ⁵⁴ Import deposits meant the obligation of importers of selected commodity groups to deposit in some commercial bank 20 percent of the value of imported products for six months into a zero-interest account. The goal of this measure was to limit imports (or to make them more expensive). The measure was canceled under the EU pressure on August 20, 1997.
- ⁵⁵ The Lombard rate was higher than before the crisis until the end of 1998, and the repo rate decreased to the pre-crisis level in the second half of 1998 (Myant 2003).
- ⁵⁶ Net inflation is the inflation purged from the influence of deregulations, tax changes and other measures that cannot be influenced by the central bank (for more on this, see BOX 29).
- ⁵⁷ The budget was approved for the government of Václav Klaus and it was compiled for expected economic growth in the amount of 2.2 percent (*HN 1999 Yearbook* 1999).
- ⁵⁸ The vice-governor Kysilka said in the context of the introduction of inflation targeting: "Inflation goal is not a forecast, it is an obligation. We are announcing to the public that we will set our monetary instruments to achieve this goal as precisely as we can" (quoted in *Hospodářské noviny*, December 31, 1997).
- ⁵⁹ For more on forecasts, see Dědek (2004).
- ⁶⁰ Škop speaks about the asymmetrical perception of inflation and disinflation risks by central banks, when the central banks are more sensitive to inflation than disinflation risks (Škop 2005). He also claims that the CNB decisions were the least asymmetrical of all central banks he analyzed. His final verdict is ambiguous and admits that undershooting can be a consequence of disinflation shocks. He was employed by the CNB.
- ⁶¹ The budget was planned with a deficit for the first time since 1989 (*HN 1999 Yearbook* 1999).
- ⁶² Horská observes that the fiscal impulse in this year amounted to 1.3 percent GDP. The general trend of decreasing public expenses is documented by Spěváček who mentions that the public consumption in 1999 amounted to only 84 percent of the 1990 level (Horská 2001; Spěváček 2001).
- ⁶³ Approximately 60 billion crowns got into circulation because of this measure (*HN 2002 Yearbook* 2002).
- ⁶⁴ The goal of the revitalization program was the financial aid to large industrial enterprises (more on this program in Myant 2003).

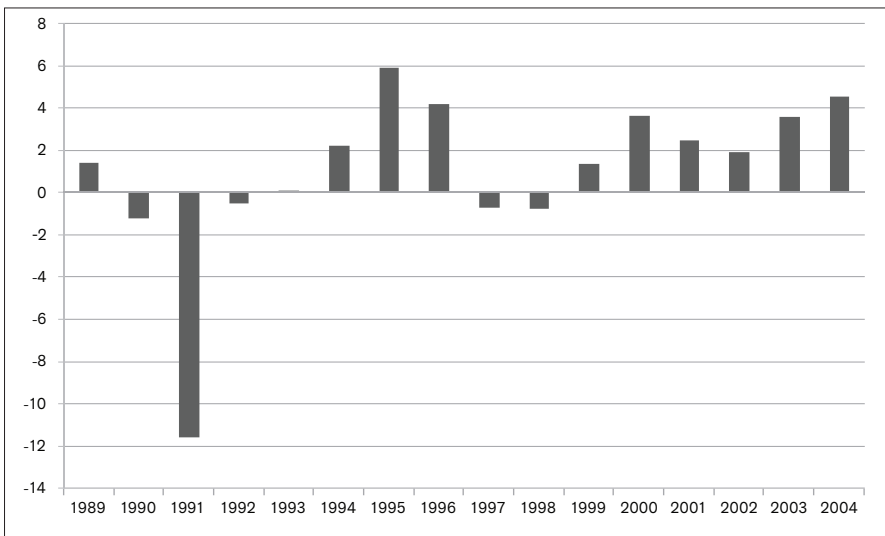
- ⁶⁵ The original plan was much more ambitious and was supposed to involve fifty-two companies, with expenses amounting to almost 100 billion crowns (Myant 2003).
- ⁶⁶ The central bank was independent before the law was passed in December 1991 (Myant 2003). Vencovský wrote that the central bank is even too independent and the bank board should include for example representatives of industry, agriculture, trade, and so on, as in Austria or Germany (Vencovský 1994). Conversely, Kvizda claims that although the central bank was formally independent, it was in fact largely dependent on the government, but the relations were quite good (cited in Dobešová 2003).
- ⁶⁷ Consulting the government (or elected representatives) is common in the Bundesbank, the Federal Reserve System (FED), or the European Central Bank (ECB) (Myant 2003).
- ⁶⁸ "It would be incorrect not to admit that some decisions of the central bank may have been different if there was a previous experience with the behavior of the economy in recession. If there was a clearer notion of the future weakness of the growth output and the inclination to deflation, the lowering of interest rates would probably happen earlier and the calibration of certain regulations of the banking supervision would probably have been more spread in time. Nevertheless, fundamental loosening of the monetary policy did occur" (Dědek 2000).
- ⁶⁹ For example, Kvizda believes the law threatened political and partly also economic independence of the central bank (cited in Dobešová et al. 2003).
- ⁷⁰ The budget for 2001 was approved in December 2000. It was the first time a social democratic government operated without the provisional budget. The deficit was planned at 49 billion CZK. The budget was assembled according to new budgetary rules that included operations with state financial assets. In essence, expenses on the restructuring of banks and industrial enterprises, and also the losses of transformation institutions (*HN 2001 Yearbook* 2001).
- ⁷¹ In 1999, the fiscal impulse was 1.3 percent GDP (Horská 2001).
- ⁷² Built-in stabilizers support aggregate demand during economic recession and dampen it during economic growth.
- ⁷³ The deficit of the pension system amounted to 197 billion CZK (Janáček and Zamrazilová 2003).
- ⁷⁴ The main and practically the only source of the increase of the financial reserve between 1997 and 2002 was the growth of net foreign assets (in 1997 and 1998 the growth of speculative capital; in 1999–2002 the inflow of direct foreign and portfolio investments; see Horská 2001).
- ⁷⁵ Komárek (for the ČSSD) proposed revaluation to 20 CSK per dollar, fearing that otherwise the Czech property would be sold abroad for absurdly low prices (Myant 2003).
- ⁷⁶ For more on the selection of the exchange rate regime, see Jonáš (1998).

- ⁷⁷ The central bank considered using other tools to increase the uncertainty on the market. The CNB considered (but did not use) haphazard selling and purchasing of foreign currencies on foreign currency markets (Myant 2003).
- ⁷⁸ The author mentions that similarly high exchange rate deviations from February 1999 are rarely mentioned in professional literature (Mach 2000).

BASIC ECONOMIC INDICATORS

This chapter focuses on the analysis of the achieved economic results. Three fundamental macro-aggregates are discussed: economic output, unemployment, and inflation—putting emphasis on economic growth.

Figure 5.1: Real GDP changes, 1990–2004 (in %)



Source: EBRD (2008).

The cyclical development of the Czech economic output after 1990 is clearly visible in Figure 5.1. The first phase of the transformation was characterized by economic recession, lasting until 1992. It was followed by the recovery phase that was characterized by a relatively strong economic growth. This

phase ended with the 1997 currency crisis and the subsequent economic crisis. After 1999, the economy recovered again and the growth phase lasted until 2008.

5.1 1990–1992: Transformation recession

At the beginning of the transformation process, all Eastern Bloc countries suffered from declining output, referred to as transformation recession (see BOX 35). It was primarily caused by the initial condition of the Czechoslovak economy as described in Chapter 1. Let us review several (major) aspects that influenced the output drop. One of the fundamental problems of the socialist economy was its entirely unsuitable (and backward) structure. To remedy this condition, it was likely that some enterprises would have to disappear. Another potential cause was the condition of micro-sphere, which was not prepared for market environment (and competition) and, last but not least, I should also mention the imbalance between aggregate demand and supply.

BOX 35 Transformation recession

Many economists view transformation recession as a specific recession caused by structural adjustment of the economy (e.g., Spěváček 2001). The character of the decline was different in comparison with the ordinary slumps because the whole economy had to adapt to the new paradigm of the market economy. Spěváček thinks that there were many specific factors that played a role in this recession—overall decline in demand, collapse of the Eastern markets, and drop in the weapons industries. There were at the same time several factors on the supply side, foremost among them termination of “production for production,” meaning companies had to produce only goods that they were able to sell on the markets; and growth of foreign competition. The companies were negatively affected by lower delivery of energies from the Soviet Union as well. The Soviet Union delivered in 1991 only half of the promised energies—lack of them harmed several sectors in the Czechoslovak economy (Goldman 1997). Kornai mentions his own set of causes of the transformation recession—the shift from a seller's to a buyer's market; transformation of real structure of the economy; the disturbances in the coordination mechanism; the macroeconomic consequences of the hardening

of financial discipline; and the backwardness of the financial system (Kornai 1994). He mentions also factors on the demand side of the economy, especially decline in propensity to invest and a drop in exports. I can add that this slump happened during a specific period in the world economy, foremost the Gulf War that led to increase in price of oil.

The transformation recession is deemed as a necessary cost of the change of the economic system (e.g., Klaus 2001). All the countries of the Eastern Bloc were affected, regardless of the pace of the reforms or the state of the economy at the beginning of the transformation process. However, some scholars do not use the term transformation recession and they even believe that it could have been avoidable (e.g., Švejnar 2002).

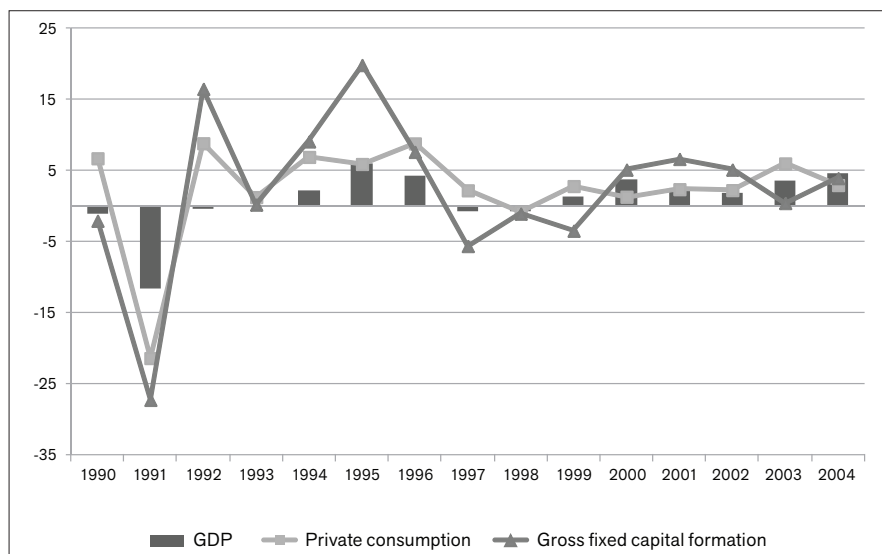
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Transformation recession began in 1990 (before the main reforms were launched),¹ but the deepest output slump took place in 1991. Most central European countries hit bottom in 1992 or 1993. The Czech Republic experienced recovery as early as in mid-1992. A cumulative GDP drop in the CR between 1990 and 1992 amounted to approximately 15 percent, one of the mildest of all transforming countries. Nevertheless, during the transformation recession, one-third of industry, one-fourth of agriculture, and one-fifth of GDP “disappeared” (Klaus 2001). Klaus believes this development was unavoidable due to system changes which rid the economy of unsustainable economic activities.

Recession factors can be found on both the demand and supply sides. In the initial phase of the transformation, practically all parts of demand were going down. But household consumption in 1990 grew substantially due to stockpiling, and even to purchasing fever related to announced liberalization. In 1991, consumption plummeted (see Figure 5.2). The economists’ expectations of another purchasing fever related to liberalization of foreign trade were not met (e.g., Jonáš 1997).

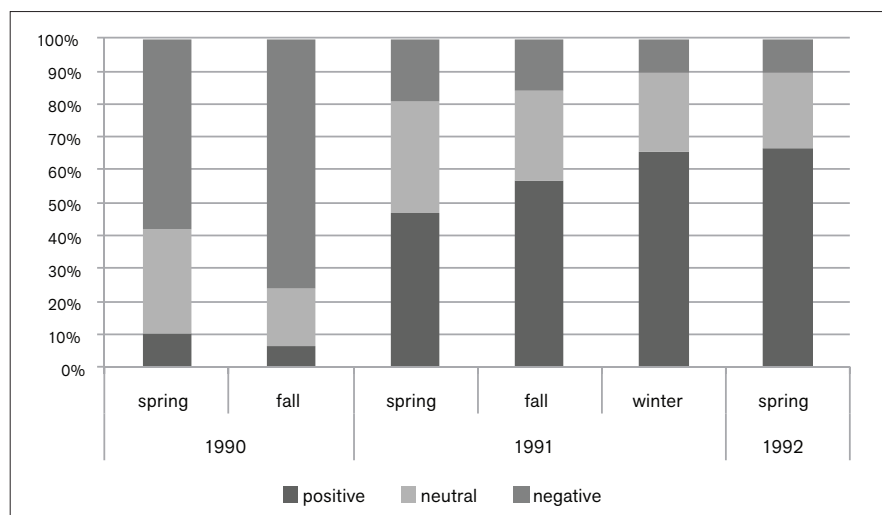
The recession had several reasons, including real income slump due to price liberalization—nominal wages grew slower than prices and therefore households were worse off. Real wages dropped by over 26 percent (Neset 2002). But immediately after liberalization, satisfaction with market supply shot up (see Figure 5.3). Another important factor in the consumption slump was increasing uncertainty. Households were concerned about future developments, especially increasing unemployment, cut down on consumption and increased savings.

Figure 5.2: Changes in GDP, private consumption, and gross fixed capital formation, 1990–2004 (in %)



Source: EBRD (2008).

Figure 5.3: Assessment of market supply in ČSFR, spring 1990–spring 1992²



Source: Koutníková (1992).

Investments decreased for similar reasons as demand and some consider their decline to be the main cause of the recession (e.g., Myant 2003). Uncertainty for corporate managements increased substantially. Enterprises did not know how the economy would operate; they lost subsidies, eastern markets were crumbling, structural changes were underway, and future ownership structures were unclear. Restrictive monetary policy and cautious commercial banks limited accessibility of loans.³ It is not surprising then that the volume of investments dropped, resulting in lower aggregate demand.

The last two components of demand—government expenses and export—followed a similar path. The government's aim was to limit the role of the state in the economy and reformers strived for lower public expenses (limited budgetary incomes constituted a concurrent factor). The development of export volume was also negative, although the net export was still positive. There were numerous reasons why foreign demand for Czechoslovak products was falling, the primary one being the disintegration of eastern markets (see Table 5.1). The disintegration of the CMEA markets accounted for approximately one third of the total GDP drop (Vintrová 1992).

Table 5.1: Year-to-year variations in export volumes in Eastern Europe, 1991 (in %)

	To former CMEA	USSR	Countries with freely convertible currency*
Bulgaria	-64	-57	-30
Czechoslovakia	-68	-63	-11
Hungary	-67	-69	15
Poland	-71	-74	-1
Romania	-60	-60	-33

*excluding exports in freely convertible currencies to former CMEA countries.

Source: Borensztein and Masson (1995).

The unification of Germany had a similarly negative impact because of lower demand for Czechoslovak products on the former Eastern German market (Jonáš 1997). There were other contributing factors—switch to trading in convertible currencies, transformation recession in Eastern Europe, orientation of eastern partners to western products, and so on. The termination of export subsidies carried out by the new government also contributed to these external factors. The trend was balanced by increasing exports to advanced markets. Exporters faced numerous problems—poor knowledge of the environment, weak marketing, and bad quality—but in several years, exports

reoriented to western markets and the volume of exports to these markets increased as early as 1991.⁴ Economic problems turned up on the side of imports as well; for example, the supplies of Russian oil decreased by 20 percent in 1990 (Klaus 1991).⁵

Transformation recession was evident on both supply and demand sides and we should not forget how intertwined the two aspects are. Several factors contributed to the development. First, limitation or cancellation of subsidies from the state budget—the enterprises had to be self-reliant. Second, growing prices of inputs (costs)—partially before price liberalization due to transition to payments in world prices and currency devaluation. Finally, management failure (Jonáš 1997). Managements were unprepared for the new conditions and unable to adapt quickly. They were used to having their sales and production financing secured and now, all of a sudden, were left to their own fates and expected to prove their viability. Many managers decided to do it the old way and wait for the state support. The supply slump also reflected the real situation in quality and scope of Czechoslovak production. A large percentage of capacities became useless in the new conditions (partly due to low demand). Conversely, there was a chance to do business freely, the numbers of businessmen grew rapidly and the supply of products and services improved.

Economic policy—both fiscal and monetary—also played its role in the total drop of output. As was mentioned before, in the initial phase of transformation, it was restrictive, aiming to prevent uncontrollable price growth (and related to concerns regarding the breakup of the state in 1992). In this context, the economic policy is often criticized for having been too restrictive (see BOX 17).

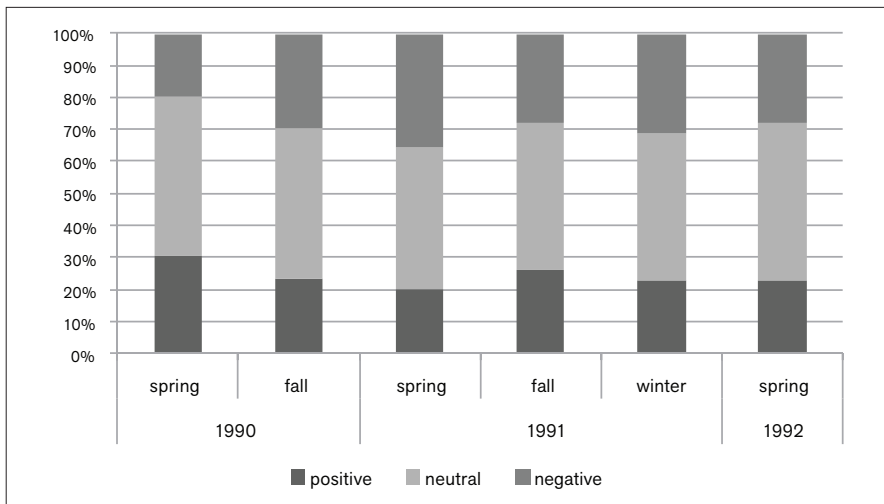
The resulting output slump was higher than both domestic and foreign economists expected. Most forecasts predicted a GDP slump of a maximum 5 percent in 1991 (e.g., Ministry of Finance and the IMF). The real numbers were more than double the value. The wrong estimation was probably caused by overly optimistic perception of the state of the Czechoslovak economy (see Myant 2003). The key issues involved oversized heavy and military industry (Slaný 2003) and general backwardness. The recession revealed the obvious necessity to reallocate economic resources, as well as the existence of demand and supply shocks.

Conversely, some economists point to the fact that the output slump in the first transformation phase was probably not as deep as the official statistics

indexes claim (CERGE 1999; Krkoška, 1999; Myant 2003). They cite several arguments—the communist regime exaggerated its results (enterprises needed to show that they met the plan); the statistical office, like other economic subjects, was not ready for the new situation and faced difficulties acquiring information about the private sector; market subjects tried to dodge taxes and lowered official outputs (this fact is better understood in the context of potential existence and expanding of gray or black economy, and the official inflation was probably higher than the real price growth,⁶ resulting in undervaluation of the real economic output (Myant 2003; see also Åslund, Boone, and Johnson 2001).

Myant also mentions that some economists paid attention to the fact that despite the lowered output, wealth in society did not decrease (Myant 2003). Central planning meant wasting, poor effectiveness, and worthless production of dead stock. Queues soon disappeared and products were of better quality. See Figure 5.4, which shows that despite real wage slump and general reform burden, people did not think that their living standard worsened dramatically.⁷

Figure 5.4: Assessment of living standards in Czechoslovakia, spring 1990–spring 1992



Source: Koutníková (1992).

5.2 1993–1996: Recovery and boom

The period between 1993 and 1996 appeared to be an era of success for the Czech transformation. First, there was the accession to OECD. Another similar external success signal was the investment rating awarded by Standard & Poor's in November 1995, the first postsocialist country to earn this rating. These external factors contributed to optimistic perceptions of the reforms and to the conviction that the Czech Republic was the leader among transforming countries. Some even described the country as a Central European economic tiger.

Such opinions were based on economic results—the economy grew rapidly, unemployment and inflation remained low, and the budget ended in moderate surplus every year. This convinced some economists that the basic transformation measures had already been completed.

However, if we go back to the beginning of the recovery phase in 1993, we will recall the negative impacts of the breakup of the state. We can classify the costs into several areas (Šujan and Šujanová 1997). First are the direct costs. This category includes such items as the emission of new banknotes and documents, costs of division of administration, army, police, federal property, and embassies abroad. Higher uncertainty meant slower inflow of foreign capital. The second area with high breakup costs involved the unavoidable decline in mutual trade, despite customs union and the establishment of a clearing account. The third issue was the termination of financial transfers to Slovakia. Total annual transfers from the Czech to the Slovak part of the federation were estimated by the OECD at 25 billion CSK, or approximately 7 percent of Slovak GDP (Šujan and Šujanová 1997). From this standpoint, the breakup was a disadvantage for Slovakia and an advantage for the Czech Republic. Estimates of total impacts vary: Šujan and Šujanová estimate -2.1 percent GDP for the Czech Republic and -5.7 percent GDP for Slovakia; Kotoučková estimates that the negative impact of the Czechoslovak breakup resulted in the lowering GDP growth by 0.5 to 1 percent in the three subsequent years after 1992 (Kotoučková 2001; Šujan and Šujanová 1997).

Despite these negative factors, the Czech economy started to grow in 1993 and it continued to do so in the years to come. Economic recovery and growth between 1993 and 1995 had the following reasons. The essential growth factor consisted in higher demand and investments. The investment boom had

several causes—impact of transformation cushions; banking sector willing to finance; and positive expectations of economic subjects resulting from the fast pace of reforms. However, some economists consider the targeting of these investments to be problematic, claiming that most investments went into infrastructure and the environment and a relatively small portion went into productions (Klaus 2000). Another problematic issue was the fact that investments were not fully covered by domestic savings (see Table 5.2). This imbalance was equalized by inflow of foreign capital.

Table 5.2: Rate of investments and gross domestic savings (shares in % of GDP)

	1995	1996	1997	1998
Gross capital formation	34.0	34.9	32.8	29.7
Domestic savings	30.4	27.2	26.7	27.8
Excess in points	3.6	7.7	6.1	1.9

Source: HN 2001 Yearbook (2001).

Consumption increase constituted yet another growth factor. Households started to buy durable goods owing to the growing supply of attractive products, including imported products; growing wealth of households because of increased real wages, income from sale of shares after voucher privatization and restitutions; and newly introduced financial services.

Domestic demand began to grow sharply—by 8 percent in 1994 and by 13 percent in 1995, mainly due to increasing fixed investments (by 15 percent) and an increasing private consumption (Hájek 1996). Factors that worked against this trend included the fact that the growth of imports exceeded the growth of exports and the government expenses were decreasing. The aforementioned impulses led to high economic growth and low unemployment—only 2.9 percent. However, in 1995, the rate of growth started to slow down. In 1996, the economy as a whole continued in the growth trend. However, the aforementioned tendencies in aggregate demand deepened. Fixed investments increased by almost 34 percent and the consumption of households grew steadily. Moreover, public consumption stagnated and the impact of foreign trade was negative (Hájek 1997).

Domestic demand exceeded the production output of the Czech economy, which contributed to inflation tendencies and in particular to current account payment imbalance. The deficit of the current account for the first through third quarter amounted to 7.5 percent GDP and to 11.4 percent in the last

quarter (Zamrazilová 1999). The central bank perceived such development as dangerous and threatening to macroeconomic stability, and resorted to restrictive measures in the mid-year (for more on this, see Chapter 4). The government, however, was not disturbed, and provided numerous arguments for its attitude. It was obvious that all transforming economies had the deficit of current account. It was widely believed that the deficit is a necessary part of any transformation process. The government claimed it resulted from the ongoing restructuring of economy, which was impossible without importing machinery and equipment from advanced countries (see Figure 6.7). The current account deficit would have been disturbing if it turned primarily into consumption. In reality, 75 percent of imports went into production and only 25 percent was consumed (Zamrazilová 1999). It was expected that the restructured productions would become a source of subsequent growth of export, naturally balancing the current account deficit (see BOX 41). Besides, exports increased competitive pressure on domestic companies to undergo restructuring.

The deficit of the current account in the balance of payments was covered by the inflow of foreign capital. Czech economy was perceived as stable and promising, resulting in optimistic expectations of foreign investors. Economic growth supported capital inflow, because investments were becoming more profitable; and, vice versa, capital inflow became a source of economic growth. Jonáš writes about the cycle in which domestic recovery led to demand growth and GDP increase which, in turn, became a source of demand growth itself (Jonáš 2000). I have mentioned the negative aspects of capital inflow in the previous chapter. Its problematic feature relied in high share of short-term component—for example, in 1995, the share of short-term capital amounted to 30 percent (Dědek 2000). Reasons included positive interest rates differentials,⁸ fixed exchange rates, which provided a fair amount of security for foreign investors, and inflow of portfolio investments to a capital market after voucher privatization, which resulted in considerable surplus of capital account in payment balance. It amounted to 3.4 billion dollars in 1994 (8.6 percent of GDP), 8.2 billion in 1995 (16.3 percent of GDP), and 4.3 billion in 1996 (7.7 percent of GDP). To reiterate, negative consequences of this inflow included the growth of money supply and the danger of economic overheating.

The situation before 1997 was, therefore, far from optimum. Domestic demand between 1995 and 1997 grew almost twice as fast as the GDP (Hájek

1997). Aggregate demand was not covered by domestic supply and therefore it was satisfied from abroad, which led to trade balance deficit and negative impact on the current account balance. The current account deficit was compensated with the inflow of capital, which later resurfaced in inflation tendencies, imports, and a growing aggregate domestic demand.

Another widely discussed topic at the time was the restructuring of enterprises; some authors believed it did not progress far enough, resulting for example in low unemployment and wages growing faster than productivity of labor. Another reason for this slow progress was the close link between banks and enterprises, which stemmed from the voucher privatization (Urban 2001).

5.3 1997–1999: Recession

In early 1997, the economy cooled down due to several factors, including the monetary restriction introduced in the middle of the previous year. And the economy was hit with other problems—slower growth in Germany and other EU countries in 1996; unfavorable weather in January 1997, resulting in building industry recession; a February railway strike; and nominal revaluation of currency starting from the middle of the previous year. Growth estimates from the previous year were proven to be too optimistic, which led to a deficit in public finances. The current account deficit in the beginning of the year amounted to 7.5 percent GDP. The government reacted by adopting the first of the aforementioned packages in April, but the measures it contained did not convince the market that the exchange rate of the crown was not overrated. The government wanted to devalue the currency within the framework of the package, but the central bank was afraid the measure would cause capital outflow and subsequent exchange rate undershooting, and did not agree (Klaus 2000; see also Dědek 2000). The currency was eventually attacked. Economic results of this year were also influenced by another fiscal restriction related to the second package and monetary restrictions in the form of high interest rates, used by the central bank in an effort to attract foreign investments and thus weaken the pressure on currency devaluation. These interest rates were gradually decreasing, but remained approximately 2 percent higher than before the crisis (Dědek 2000).

Another blow to the economy came in July when the country was hit by disastrous floods causing damage estimated at 60 billion CZK and a drop in budget revenues estimated at 10 billion (Hájek 1997). The floods' global impact was estimated at 1 percent GDP (Hájek 1997). The government issued bonds to cover the damages, but the fiscal restriction took effect concurrently (delayed by 6–8 months; see Janáček et al. 1999).

All these factors resulted in recession of aggregate demand—government spending, gross capital forming and rate of consumption growth were falling (in 1996, household consumption grew by 7 percent, while in 1997 only by 1.6 percent [see Figure 5.2]). The only component of aggregate demand that progressed in a positive direction was the foreign trade, profiting from weakened currency and recovery in Germany and Slovakia. Under such circumstances, no wonder that the entire economy was weakened and the GDP dropped by 0.7 percent (ČSÚ 2004)—more about the crisis see BOX 36.

BOX 36 Sources of the crisis

The economic crisis that followed after monetary turbulences in the spring of 1997 can be considered standard, as opposed to the crisis in the early 1990s. This recession was widely discussed at the end of the 1990s. It certainly contributed to the dramatic assessment of the development, when some domestic analysts described the economic situation as bordering on a catastrophe (Sojka 2001). The crisis was directly caused by dropping consumption and investments. Opinions concerning causes thereof vary. Many claim the recession was to a great extent caused by economic policy—especially the monetary policy, which was not adequate to the situation (Janáček et al. 1999; Klaus 2000). Others see the cause in Czech institutional environment (e.g., Pick 2000), while some look for other specific factors. Let us take a closer look at the individual opinion groups.

The monetary policy was criticized for tight restrictions in mid-1996, which brought the economy a recession with a “textbook” delay in the beginning of the following year (Kubiček 2002), often supported by reference to a lower rate of M2 growth. Furthermore, the CNB became a target of criticism once again, after subsequent substantial undershooting of its ambitious inflation targets in 1998 and 1999, which some claim deepened the recession. Opinions, of course, differ.

Dědek (2000)—then the vice governor of the CNB—maintains the crisis was caused by external imbalance (current account deficit), which originated because of “institutional bottlenecks.” These led to a situation in which the

economy overheated already at moderate growth rates and the supply did not keep pace with the demand. The situation was aggravated by wage growth exceeding the growth of productivity of labor and the nontransparent burdening of public budgets with debts. Under such circumstances, the government was not willing to cool down the economy and the central bank had to act. He defends the measure of restriction by arguing that the M2 growth rate decrease was caused by decreased inflow of foreign capital. Even the steep rate increase in mid-1996 did not force the banks to limit loan granting, because they had excessive liquidity sterilized by the central bank already before the measure was taken (CNB 2003). Sommer and Tůma defend the CNB policy, saying that the central bank was alone in its struggle with macroeconomic imbalance and it had to react to expansive fiscal policy (Sommer and Tůma 1999). Myant opposes such arguments and claims that the economy was slowing down some time before monetary measures and that the fiscal policy of the government was not too relaxed either (Myant 2003). He says that the budget deficit at the end of 1995 was small. Moreover, IMF statistics showed data similar to official Czech statistics, excluding the Consolidation Bank. But Myant admits that the fiscal expansion before elections could have been problematic—retirement pensions were increased by 7–8 percent and wages in the public sector by 15.6 percent (Myant 2003). These measures could have led to an increased rate of inflation, aggregate demand, and import. In general terms, the author agrees that the monetary restriction was too strong. Dlouhý believes that stricter monetary policy was a step in the right direction, but that it was too strong (Dlouhý 1999). He claims the monetary policy was not the primary cause of the crisis, but it contributed to its earlier beginning. Another reformer writes that the monetary restriction was the primary reason of the recession (the secondary reason being the fiscal restriction; see Kočárník 2000). Kočárník used the rate of growth of the M2 aggregate as an argument. He also notes that no later than in April 1997, the CNB predicted economic growth of 3–4 percent, so the bank misestimated the impact of its own measures. Czesaný provides a similar explanation—the recession was caused primarily by late abandoning of a fixed exchange rate, the source of excessive inflow of foreign capital (Czesaný 2005).⁹ The economy thus suffered from too many loans and too much investment. The subsequent monetary restriction led to stoppage of loan granting. As a consequence, the recession lasted longer because of costs. The level of real interest rates is a good indicator of monetary policy; it was entirely outside long-term trends in 1997 (see Table 5.3).

Table 5.3: Real interest rates in the CR, 1994–2003 (in %)

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
2.5	3.0	3.5	7.4	2.5	3.3	1.9	0.5	2.0	1.3

Real interest rates—nominal rate 12M PRIBOR (December median value)
deflated by interannual growth of consumer price index.

Source: Czesaný (2005).

In the issue of very quick subsequent disinflation and undershooting of inflation target, the central bank argues similarly as with the causes of recession (see BOX 29). “The causes of undershooting lie entirely or to a great extent outside the competence of the CNB” (CNB 2003). Myant says that until mid-1998, each uncertainty represented a good reason not to decrease interest rates (Myant 2003). As an example, he quotes foreign financial crises, individual monthly results of foreign trade or the danger of deficit. Klaus maintained that the CNB policy was too ambitious, and Janáčková joined him in this criticism (Klaus 2004; see also Janáčková 2000). Janáčková quotes data about M2 variations—this index grew by 20 percent in 1996, by 10 percent in 1997, and by only 5 percent in 1998.

Numerous authors claim that the government packages made the recession deeper (e.g., Klaus 2000). Spěváček believes that the factors responsible for recession involved monetary and fiscal policy, institutional factors (insufficient restructuring of banks and enterprises), and external influences (Spěváček 2001). The IMF economists see direct causes of the crisis in the restrictive fiscal and monetary policies (IMF 1999). They argue that the general government deficit stayed unchanged (at 2 percent of GDP) between 1997 and 1998 and that implied tightening because the economy slowed down meanwhile. They also deem monetary policy as tight until 1998 but they have some understanding for the central bank that had to face a difficult situation in the international markets. At the same time, they stress that there were deep roots of the problems. They think that the causes lay in: “weak corporate governance in banks and enterprises, the substantial capital inflows received in the mid-1990s, as well as the large concomitant increase in domestic credit, were used to support substantial real wage increases, misguided investments, and ‘tunneling’ operations. This in turn led to an excessive growth in private consumption, an unsustainable widening of the external imbalance, and ultimately an exchange rate crisis” (IMF 1999). Economic policy according to their view only reacted to these imbalances in the economy.

Another group of authors ascribes the recession to institutional and structural factors—especially underestimated reforms of legal system, enforceability of law, and ownership rights, or insufficient restructuring of economy (Pick 2000; see also Dillon and Wykoff 2002). Kotoučková writes that the principal reasons for the crisis were in insufficient microeconomic adjustment (Kotoučková 2001). Sojka sees the causes in recession of all components of aggregate demand, but he also finds deeper causes of noncyclical nature, namely “fatal errors in transformation strategy” in the form of privatization (Sojka 2000).¹⁰ However, Loužek argues that the institutional factors did not cause the crisis (Loužek 1999). He claims that institutional factors have a long-term impact; their influence cannot be proven directly; and imperfect institutions existed for the entire duration of transformation and did not originate in 1997; in fact, they were starting to improve then. He also argues against the notion that institutional impacts should negatively influence potential economic output and that the state should thus react with stricter economic policy. Loužek asks whether Czech institutions were worse than in other transforming countries and, if so, whether it was the reason for stricter economic policy. His answers to both questions are negative.

Still more authors mention other specific causes. Holman claims that the recession resulted from the previous investment activity, as some investments turned out to be bad (Holman 2000). When the investors found out, investments, consumption, and imports declined. In his opinion, monetary policy was not the sole cause of the recession, but the central bank was responsible for its deepening.

Janáček and colleagues write about coincidence of causes—simultaneous decrease of investments and durable goods consumption, and concurrent errors in economic policy, caused by objective ignorance of economic relations (Janáček et al. 1999). They deem institutional and structural factors marginal, because they influence long-term growth rather than economic cycles.

Klaus presents a unique theory (Klaus 2004). He believes that some subjects who were interested in Czech assets were not fully satisfied with the Czech model. Klaus claims that these subjects tried to change the situation to get hold of originally privatized (or yet-to-be privatized) assets by discrediting chosen privatization methods and harming the existing assets (private and state-owned) to make them cheaper. The only way to achieve this goal was bringing about recession. He says that an “amorphous coalition of domestic and foreign subjects” attempted this strategy (in 1996 and 1997) and was

successful to a great extent (Klaus 2004). The economy as a whole was hurt in the process.¹¹

In my opinion, the roots of the crisis are in the economic policy. I do not find institutional arguments convincing. I want to make it clear that I do not underestimate institutional factors. I do, however, think that these are essential for long-term progress in terms of influencing the potential product—in other words in long-term ability of the economy to grow. Bad institutions produce slower potential growth, but cannot cause an economic crisis. Besides, if the cause was really institutional, the identical crisis should have occurred in other similar countries—for example in Slovakia—as argued by Kubiček (2002). I see the principal cause restriction enforced by the government and especially the central bank. I should stress that the restriction by the central bank embraced not only increase in interest rates but stricter conditions for the operation of the banking sector as well. This measure also significantly contributed to weaker investment activity. The central bank certainly has the right to make mistakes (such as excessive restriction), especially in uncertain and insecure times. But (as I claimed previously in the text) it should take responsibility for its measures and admit errors openly (i.e., acknowledge that the restriction was too strong). But no such admission, as far as I know, has taken place explicitly. If dramatic disinflation occurs during economic downturn (as it did) and the disinflation also means dramatic undershooting of the central inflation target, then the disinflation had to influence the length and depth of the recession—a fact the central bank should admit. By this I do not mean to claim the CNB policy was the only factor behind the length and depth of the recession. Fiscal measures undoubtedly played their role, as well as floods and the currency crisis itself, which led to the loss of confidence, higher savings, as well as lower consumption and investments. The political insecurity at the time worked in the same direction.¹²

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The declining trend continued in 1998. The GDP dropped by –0.8 percent, including all components of aggregate demand (except for net exports), resulting in lower consumption and investments. This development was a follow-up to a decline in the confidence in the economy and fairly steep growth of unemployment, which led to increased household savings. Conversely, previous economic imbalances were eliminated—the deficit of current account plummeted and wage growth slowed down as well. The former decreased despite the fact that the exchange rate of the crown exceeded

the precrisis level as early as October. Economic imbalance declined but at the expense of lower output (see Table 5.4).

Table 5.4: Macroeconomic balance (billions of CZK in 2015 prices)

	1996	1997	1998
Domestic demand	1,673	1,780	1,847
Final household consumption	800	880	937
Final government consumption (including nonprofit institutions)	323	343	363
Gross capital forming	550	557	545
Domestic supply (GDP)	1,572	1,680	1,821
Balance	-101	-100	-26

Source: HN 2000 Yearbook (2000).

5.4 1999–2003: Recovery and growth

After 1999, the economy embarked on the phase of recovery, which lasted with a few fluctuations until 2008. Household consumption was an important factor. Impact of foreign trade was unsteady.

The main propeller of the 1999 recovery was in exports, directed mainly toward the EU. Foreign influence on the Czech economy was already very strong—the share of exports in GDP was 60 percent. But moderate economic growth (1.3 percent) had no impact on the unemployment, which increased. Household consumption rose after the previous year's slump. Net investments dropped substantially (5.5 percent), mainly due to high interest rates and the reluctance of banks to grant loans. External imbalance and inflation lowered. Industrial production was in recession.

In 2000, the economy was fully in the phase of recovery. Economic growth amounted to 3.6 percent, well above the expectations of most economists. The main growth factor consisted in investments in fixed capital, especially machinery and technological equipment (Janáček et al. 2001). Foreign direct investments were of utmost importance (*HN 2001 Yearbook* 2001). Building and construction investments began to grow in the second half of the year. Consumption increased as well and consumer loans were gaining importance. Recovery in Western Europe led to higher exports. Industry started to grow substantially owing to growing productivity of labor, which grew almost four times higher than wages (Janáček et al. 2001). Many authors claim this was the main reason why Czech exports succeeded in global markets.

The year 2001 witnessed continuing economic growth (2.5 percent). The essential factor was domestic demand, both investment (growth by 7 percent) and private household consumption (increase by 3.7 percent). Economic boom in Western Europe also contributed to the GDP growth, but it weakened throughout the course of the year. Industrial production grew rapidly (especially in the first half of the year), but then came the slowing down in the west and it decelerated. Increased investments played an important role in the recovery. However, domestic savings in this period were permanently lower than the rate of investments—fixed capital and inventory level change (see Table 5.5). The difference of 4 percent corresponds to over 80 billion crowns (*HN 2002 Yearbook 2002*). This deficit was covered mainly by the inflow of direct foreign investment.

Table 5.5: Rate of investment and gross domestic savings, 1995–2003 (shares in % of GDP)

	1995	1997	1998	1999	2000	2001	2002	2003
Gross capital formation	32.0	30.6	29.1	27.8	28.3	27.7	26.3	28.2
Domestic savings	29.9	26.0	28.1	25.8	24.9	24.5	22.6	22.6
Balance in points	2.1	3.4	1.0	2.0	3.4	3.2	3.7	5.6

Source: HN 2004 Yearbook (2004).

The GDP growth dynamism was also visible in the unemployment rate—first, it dropped from 9.1 to 8.1 percent, and then, in the second half of the year, it increased to 8.9 percent. Productivity of labor, compared to western countries, remained low; according to the exchange rate, it was only 35 percent of the German level, and according to purchasing power parity—60–68 percent (*HN 2002 Yearbook 2002*). Moreover, the productivity growth rate slowed down from 5 percent to 3.8 percent in 2000. But still, the result was very good compared to the period from 1997 to 1999, when the productivity growth was only 1 percent.

In 2002, the economic growth rate slowed down again to 1.9 percent, partly due to floods. The main growth factor was the increase in household consumption by 3.8 percent; especially the younger and middle-age generations intensively used consumer loans and mortgages (Janáček and Zamrazilová 2003). Year-to-year industrial production increased by 4.7 percent, namely owing to foreign-owned enterprises, which accounted for approximately 50 percent of total revenues in the sector. Weak foreign demand—both in the EU and globally—was a negative factor (*HN 2003*

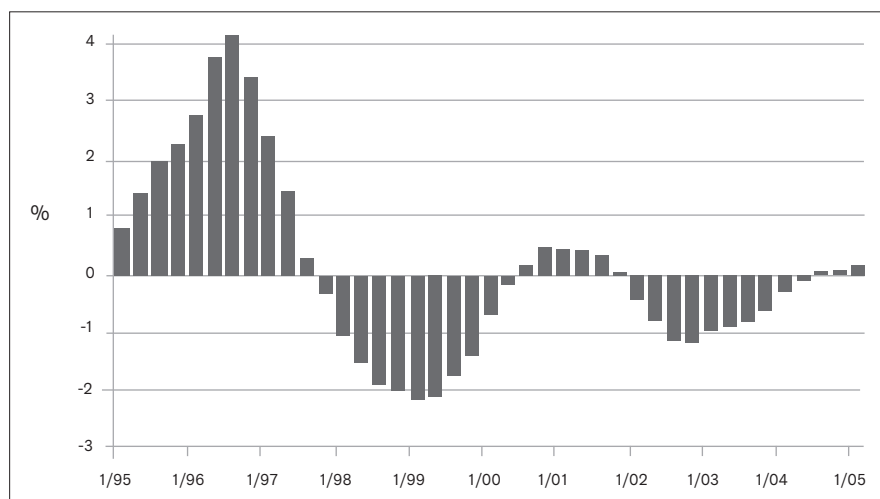
Yearbook 2003). Record-low inflation also played a role in the increasing domestic consumption—year-to-year consumer prices grew only by 1.8 percent, production prices spent the entire year in deflation band, and interest rates were at all time low. Investments grew only by 0.6 and did not play a decisive role in the growth. The balance of services became the main carrier of the floods' negative influence—it plummeted by 37.5 billion CZK due lower interest of foreign tourists. The trading balance deficit decreased due to improved exchange relations, but both exports and imports in current prices decreased, mainly because of strong currency and decline of raw material prices on global markets (Janáček and Zamrazilová 2003). Unemployment increased by nearly 1 percent, offer of job vacancies and demand for jobs from the industry sank. Nominal wages grew by 7 percent, real wages by 4.9 percent, considerably exceeding the growth of productivity of labor—2.1 percent (*HN 2003 Yearbook* 2003).

Economic growth rate increased to 3.6 percent in 2003, regardless of the negative impact of weak demand abroad, especially in Germany. On the supply side, increased household demand played a positive role once again. Consumption increased by 5.5 percent (Janáček and Zamrazilová 2004), as well as gross fixed capital forming by 3.7 percent. Industrial production grew by 5.8 percent.¹³ Year-to-year growth of consumer prices was only 0.1 percent and in several months prices were even slightly dropping. Despite faster economic growth, unemployment increased again and, in February, exceeded 10 percent for the first time. A considerable productivity increase of labor by 3.6 percent was overshadowed by the growth of real wages again (6.7 percent). Productivity of labor when adjusted to the exchange rate amounted to approximately 40 percent of German level, and according to parity approximately 75–80 percent (*HN 2004 Yearbook* 2004). The deficit of the current account climbed to 6.2 percent GDP in 2003. Foreign trade deficit was less than 70 billion CZK, and the deficit from oil imports was approximately 70 billion as well (*HN 2004 Yearbook* 2004). This development is not surprising because the price of mineral raw materials and metals increased by 43.6 percent over the year, while the price of oil increased by 7.9 percent (Janáček and Zamrazilová 2004).

5.5 Output comparison

Having overcome transformation recession, the economy underwent cyclical development, shown in Figure 5.5. According to analysis prepared by the economists from the ministry of finance, since the 1997 economic crisis Czech economy has remained mostly under its potential product that is, under the highest achievable output that does not cause inflation.

Figure 5.5: Production gap in the Czech economy, 1995–2005



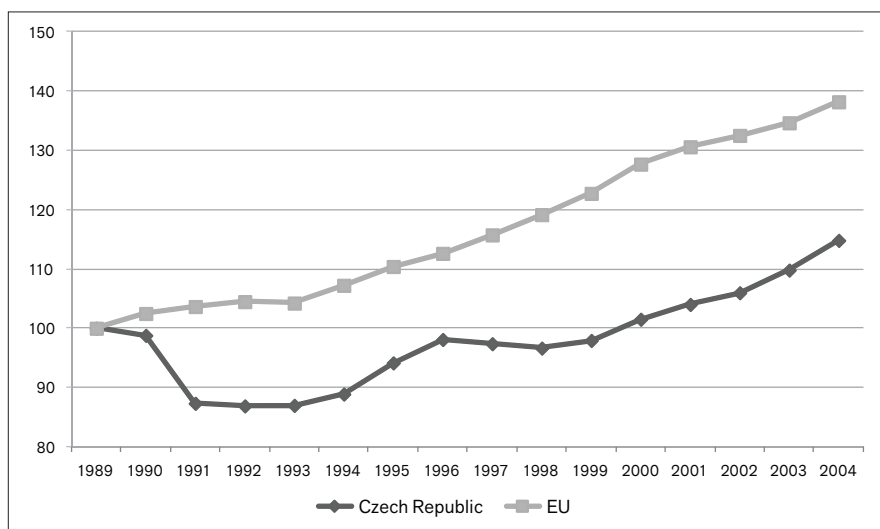
Source: MFČR (2005).

If we analyze the total output of Czech economy in the monitored period we will see that the GDP level of 1989 was exceeded at the end of the transformation decade (see Figure 5.6).

Because of transformation recession, the country was relatively lagging behind the output of the EU economy. In 1990 it amounted to 69 percent of the EU level, but in ten years the gap increased by almost 10 percent (Slaný 2003). I want to draw attention to some points in this context. First, the initial level is quite dubious. It seems very likely that socialist statistics overestimated the condition they were in. Second, the qualitative leap of the Czech economy was huge—from shortage economy with deformed market structure to functioning market economy (Dědek 2001). The quality of products was incomparable to what had been manufactured a decade before. The volume of production in

the beginning of transformation is questionable—it was characterized by production of dead stock that nobody wanted to buy. Such productions were included in the output, but in reality it was production for its own sake.

Figure 5.6: Real GDP growth in the CR and the European Union, 1989–2004 (1989 = 100)



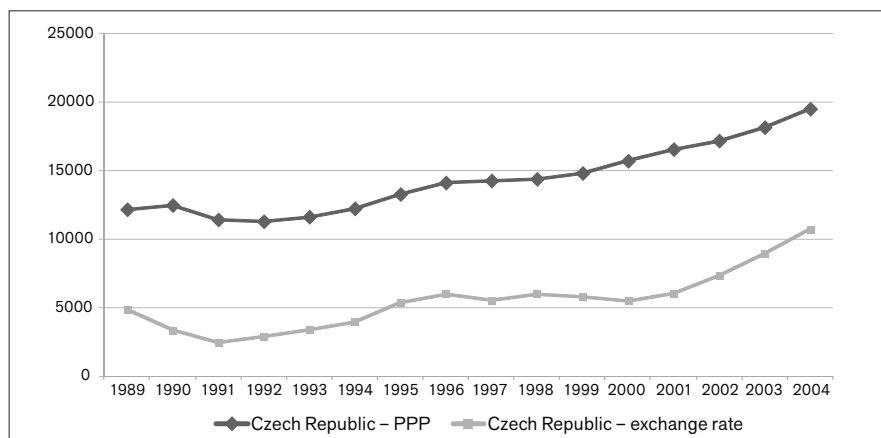
Source: EBRD (2008); IMF (2012).

Besides, because of the relatively stable nominal exchange rate and the growth of domestic price level (i.e., strengthening of the real exchange rate), GDP per capita (expressed in euro or in dollar) was converging since 1991. Better results are achieved when we measure GDP per capita according to the purchasing power parity. Both of the measures are depicted in Figure 5.7.

An analysis of the sources of economic growth can be rather interesting. I have already mentioned that the origins of economic growth can be generally extensive and intensive. The former means that we put into the economy more sources and produce more, and the latter that we use the current sources in a better and more efficient way. Economic growth is caused by combination of both of these factors but one prevails. One of the estimations of this division for the Czech economy is provided by Mihola (2007; see also Table 5.6). The sources of growth are divided into labor and capital and total factor productivity. The last two lines in the table show percentage estimation of the impact of the intensive and extensive factors on growth in the respective

years. We can see that economic growth in the Czech economy between 1995 and 2005 was caused mainly by intensive factors, on average 85 percent. It is generally not surprising because the economy lags behind the developed economies especially in productivity and if it catches up in the future, it must improve this aspect.

Figure 5.7: GDP per capital in the Czech Republic, according to the exchange rate and purchasing power parity, 1989–2004 (in USD)



Source: EBRD (2008); IMF (2008).

Table 5.6: Parameters of intensity and extensity in the Czech economy, 1995–2005 (in %)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	95/05
Real GDP	4.2	-0.7	-1.1	1.2	3.9	2.6	1.5	3.2	4.7	6.0	2.5
Labor	-0.4	0.2	-2.3	-4.1	-0.5	0.4	1.5	-0.1	0.1	0.9	-0.4
Capital	2.9	1.9	2.1	1.7	1.9	1.8	1.2	1.5	1.8	1.2	1.8
Sum of inputs	0.8	0.4	0.7	-1.7	0.2	1.2	0.1	0.5	0.7	1.0	0.4
TFP*	3.4	-1.1	-1.8	2.9	3.7	1.4	1.4	2.7	3.9	4.9	2.1
Extensity	18	27	27	-37	4	46	8	15	16	17	15
Intensity	82	-73	-73	63	96	54	92	85	84	83	85

* – TFP – total factor productivity

Source: Mihola (2007).

I can also add information about the development of the grey economy.¹⁴ There probably was growth of the share of the grey economy in GDP during the transformation process. But the estimations of grey economy notoriously vary. The Czech Republic is usually depicted as an economy with a relatively

small share of the grey economy. We can see one of the estimations in Table 5.7, which presents several countries for comparison.

Table 5.7: An estimation of the size of the grey economy
for selected countries,
1999/2000 (as percentage of official GDP)

Country	Share of the grey economy
Czech Republic	19.1
Hungary	25.1
Poland	27.6
Bulgaria	36.9
Austria	14.3
Greece	28.7

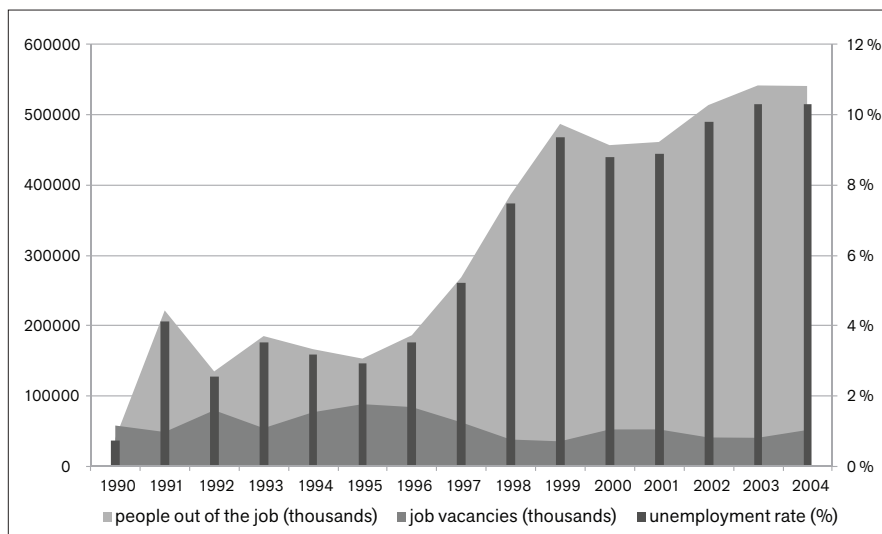
Source: Schneider (2005).

5.6 Unemployment

Unemployment rate in the course of transformation period went through an interesting development. The situation at the end of the 1980s was ambiguous. There was overemployment, amounting by some estimates to 400,000–500,000 people (Pellešová, 2002). Yet some branches suffered from lack of employees (Slaný 2003). Unemployment at the beginning of 1990 was only 0.1 percent.

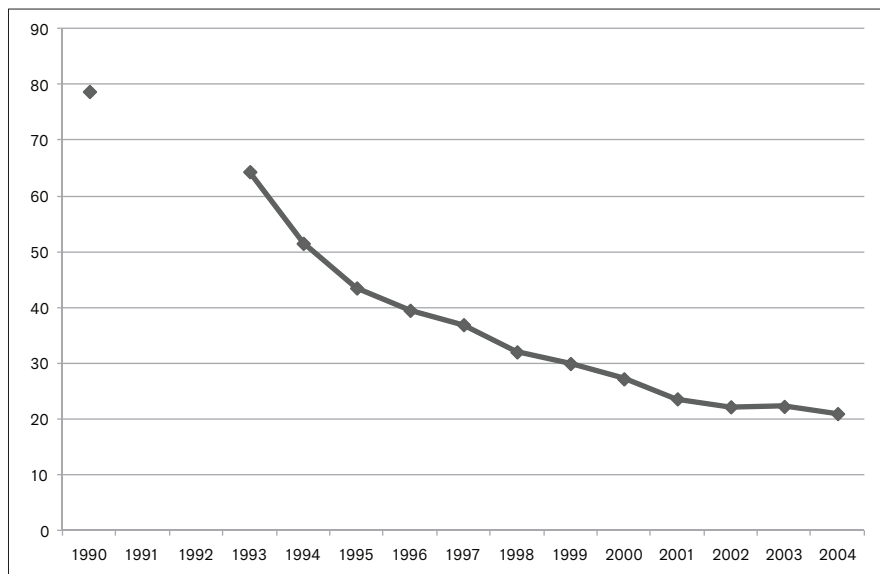
Since the beginning of transformation, unemployment in the two parts of the state developed differently and it became a source of tension between the political representations. In 1992, unemployment in the Czech Republic peaked at 4.4 percent, but 12.7 percent in Slovakia (Švejnar, Terrellová, and München 1997). A comparison with other transforming countries brought similar results. The Czech Republic had an exceptionally low rate of unemployment in the region; around only 3 percent until 1996. Several reasons were quoted—good skills in the Czech workforce; high level of education (for example Gitter and Scheuer 1998);¹⁵ working three-party negotiations (Fawn 2000); active government policy in the labor market (Jonáš 1997); geographic location (unemployment was lower near the Austrian and German borders (Švejnar et al. 1997); small percentage of labor employed in the agriculture; and underdeveloped sector of trade and services capable of absorbing people dismissed from other fields. I should mention a low level

Figure 5.8: Labor market, 1990–2004 (as of December 31)



Source: ČSÚ, Czech Statistical Yearbook, 2005.

Figure 5.9: Membership in trade unions (percentage of the labor force)



Source: OECD (2012).

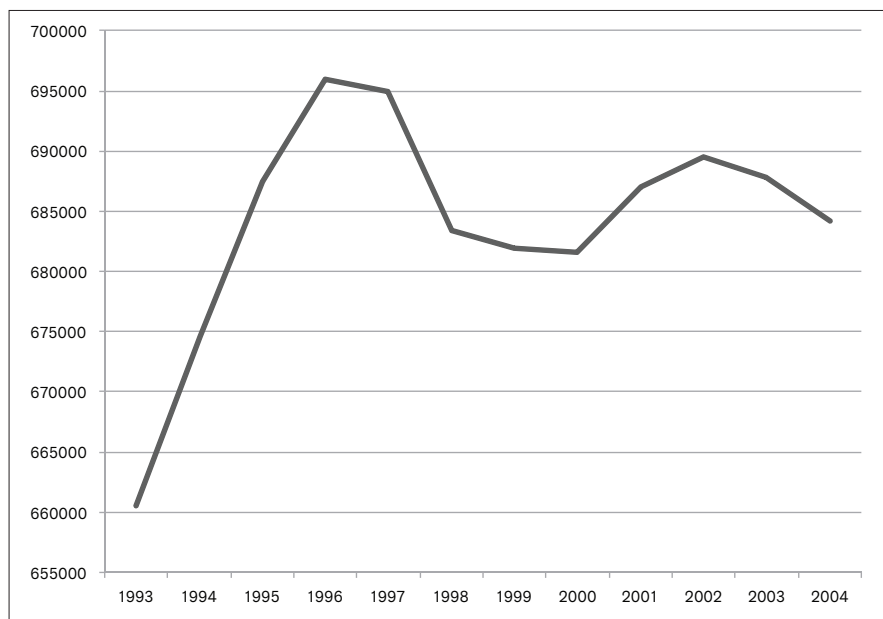
of trade union activity at the beginning of the transformation period as well. Trade unions became more active only in the mid-1990s. Membership in trade unions declined continuously throughout the whole transformation period (see Figure 5.9).

Factors that decreased the supply of workforce appeared to be important as well. High participation of seniors and women on the labor market was a typical feature of socialism. These indicators began to decrease in the initial years of transformation—tens of thousands of seniors retired¹⁶ and thousands of women became housewives. Maternity leave was extended from two to three years. Some people found jobs abroad and some moved into grey economy (Jírová 2001). The percentage of the economically active population dropped. Moderate wage policy, including wage regulation, also contributed to low unemployment. Labor expenses were kept low and attractiveness for foreign investors increased. According to some authors, the expansion of private businesses was one of the factors decreasing pressures on unemployment growth (Schützová 2000). The state enforced an active employment policy, providing retraining and subsidizing new jobs in private businesses (Švejnar et al. 1997). Employment offices were applauded during the first stage of transformation for the ratio between the unemployed and employed clients, which amounted to 30 unemployed per 1 employed, compared to 200 in the advanced western countries (Gitter and Scheuer 1998). Conversely, the state was strict toward the unemployed (Fawn, 2000). Unemployment benefits were relatively low and limited to six months. In essence, the government policy was oriented against abusing unemployment benefits (Jírová 2001).

Between 1990 and 1996, employment in industry declined by 480,000 people (Gitter and Scheuer 1998). Nevertheless, mainly large enterprises were not too eager to increase their effectiveness and therefore overemployment remained a problem (Schützová 2000). Other authors claim that the main cause of low unemployment in the initial phase of transformation was slow restructuring (e.g., Sojka 2000; see also section 9.4 in this volume).¹⁷ An OECD report testified to the same—it claims that in 1992, there were 350,000 redundant employees on the payrolls of Czech enterprises. If these people were ranked among the unemployed, the unemployment rate would jump from 3.5 to 10 percent (Gitter and Scheuer 1998). It is interesting to see that contrary to right-wing rhetoric, the number of employees in the government institutions increased significantly between 1993 and 1996 (see Figure 5.10).

Regardless of the changes in the number of government employees, their share in the overall employment was stable—between 13 and 14 percent—for the whole transformation period.

Figure 5.10: Number of employees working for government institutions, 1993–2004



Source: ČSÚ (2012).

Regardless of the previous considerations, it is clear that unemployment was, to a certain measure, present in the Czech economy. Its reasons were principally structural, resulting in considerable regional differences. At one end of the scale there was Prague with its everlasting low unemployment rate that was able to absorb a large amount of labor force from different parts of the country. At the other end, there were regions with heavy industry, such as northern Bohemia and Moravia, and the border/mountain regions with high concentrations of agriculture before 1989. Politically, it was important that the unemployment rate remained relatively low throughout the entire transformation process.

Unemployment began to climb during recession after 1997. The ability of the economy to absorb the workforce weakened. The situation became tougher namely for groups that are more difficult to employ, such as young

people, people with no qualification, graduates, women coming off maternity leave, and the handicapped. The regional differences became more apparent.¹⁸ Areas with structural problems were hit harder. At the end of 1997, total unemployment exceeded 5 percent for the first time, and it climbed to 7.5 percent at the end of 1998. However, Jírová maintains that some enterprises, especially the larger ones, were still overstaffed.

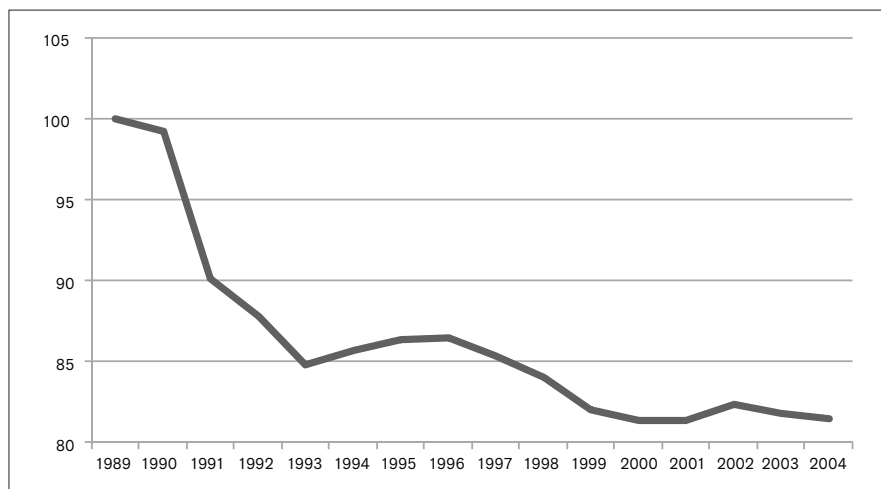
Post-1999 economic recovery did not bring a permanent drop in unemployment; rather the rate stagnated and then increased. Limited absorption capability of the Czech economy was thus fully revealed. Moreover, people were not motivated to find work because of relatively high unemployment benefits compared to the minimum wage. Some blame the liberal policy of allowing companies to employ foreigners, criticize low labor mobility and high labor costs—wages, social welfare, and health insurance (Jírová 2001; Pellešová, 2003) and the measures of the social democratic government, such as increasing minimum wage, regulation of working hours and overtime, which limited the flexibility of the labor market (Musil cited in Dobešová 2003). Jírová also points to the growing influence of trade unions in the economy (Jírová 2001). Due to increasing unemployment, tendencies from the previous era became ever more apparent, and it was extremely difficult for the people without a higher education to find jobs. Long-term unemployment became a permanent phenomenon. At the same time, foreign employees entered the Czech labor market, usually taking unskilled positions.¹⁹

The unemployment rate kept growing in 2002, when economic growth slowed down, and it climbed to 9.8 percent. The social democratic government of Miloš Zeman thus did not succeed in limiting unemployment. Its growth trend continued in 2003, although the rate of economic growth increased. Janáček and Zamrazilová therefore deduct that Czech unemployment is primarily of structural nature (Janáček and Zamrazilová 2004). They also note that the long-term unemployment was becoming more widespread; at the time of their research, approximately 50 percent of the unemployed were without a job for one year and longer. Two-thirds of the unemployed had only an elementary education, while college graduates were almost certain to find jobs.

We should not be surprised that the rate of employment significantly declined during the transformation process (see Figure 5.11) as the rate was artificially high during the centrally planned period. The sharpest decline took place at the beginning of the 1990s and the rate remained relatively

stable since 1993. I should add that the decline in the Czech Republic was relatively low in comparison to other transforming countries.

Figure 5.11: Cumulative changes in the rate of employment (1989 = 100)



Source: EBRD (2008).

Job stratification has settled—in 2003, entrepreneurs who employed other people represented 4 percent of all working people; entrepreneurs without employees and with collaborating family members 12 percent; and employees including members of producer cooperatives 84 percent. According to another classification, managers, scientists, and professionals represented 16 percent; technicians, health professionals, and teachers—20 percent; lower administration and officials—20 percent; qualified workers, craftsmen and manufacturers, repairmen and machine operators—36 percent; and helping-hands and unqualified workers—8 percent (*HN 2004 Yearbook 2004*).

5.7 Inflation

Czech economic policy during transformation was quite successful at managing inflation. There were two inflation leaps—at the beginning of 1991 due to price liberalization and then a smaller one in 1993 after the implementation of the new tax system. Except for the aforementioned years, annual price

growth until 1998 was around 10 percent and then it plummeted. The price level thus developed in accordance with the historical trend—Czechoslovakia did not suffer rapid price growths like the neighboring countries. Even in socialism, fiscal and monetary policies were fairly conservative and growth of wages moderate, which meant that inflation pressures, compared to other Eastern Bloc countries, were not strong (Tomeš 2000).

I have already mentioned partial measures implemented in 1990—removing negative turnover tax, modification of selected prices (for example, gasoline), and currency devaluation, which led to price growth on the eve of price liberalization. The price level increased by 9.7 percent in 1990. A price leap occurred at the beginning of the following year, mainly due to price liberalization that meant revealing of formerly suppressed inflation. Devaluations in the previous year, switching to payment in world prices in trade with other former socialist countries, worse exchange relations with the former USSR republics, and abusing of the situation by home monopolies also contributed (Sachs 1993; see also Neset 2002).

Table 5.8 shows that inflation pressures came primarily in the beginning of the year.²⁰ They were suppressed quickly (with restrictive policy). Hanousek and Krkoška maintain that if the January inflation rate continued throughout the year, annual price growth would amount to 1,760 percent (Hanousek and Krkoška 1997). However the 1991 price growth forecast was only 30 percent, but the real number was almost 57 percent at the end of the year (Myant 2003). Klaus wrote that he had to react to the criticism that inflation exceeded the expected level: “none of us was able to forecast whether the inflation would be 31 percent or 41 percent, because everything depends on the behavior of millions of consumers and thousands of producers” (Klaus 1991).

Table 5.8: CPI growth in 1991

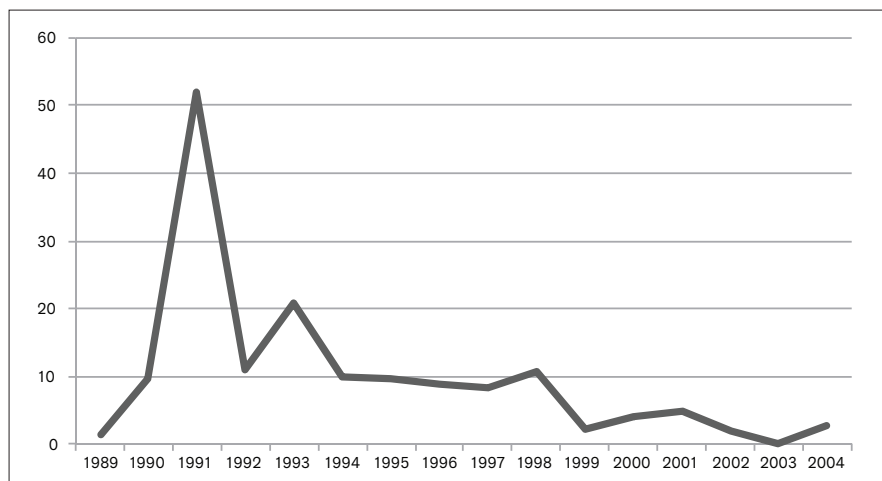
January	February	March	April	May	June
26	7	4.7	2	1.9	1.5

Source: Federální statistický úřad (1992).

Price growth in the following year was slightly over 10 percent, a good result among the post-socialist countries. In the initial years of transformation, there was no hyperinflation in the CR (and in entire Czechoslovakia). On the one hand, it meant that household savings were not affected as hard as in countries with higher inflation. And companies did not get rid of their debts

because of low inflation (Šároch 2001). For subsequent price level developments, see Figure 5.12.

Figure 5.12: Inflation rate, annual increase of average CPI in the CR (previous year = 100)



Source: EBRD (2008).

Once the shock of the early 1991 events faded away, the price level stabilized quickly and the price growth remained within acceptable limits the next year as well, owing to relatively low excess of demand over supply in the era of planned economy, low rate of indexation, restrictive economic policy and fixed exchange rate. But, in the initial years of transformation (1990–1992), Czech prices of tradable goods were drawing near European prices quickly. The differences remained in the prices of nontradable commodities (Tomeš 2000)—for explanatory theory see BOX 37.

BOX 37 The Balassa-Samuelson effect

The Balassa-Samuelson effect explains changes in labor productivity and wages between tradable and nontradable sectors of the economy. During transformation, the sector producing tradable goods increased its productivity due to, for example, international competition or inflow of foreign investments. According to the Balassa-Samuelson effect, this is why real wages approach the level of wages in advanced countries. The wage increase in the tradable sector is carried over to the nontradable sector (services), where it is not

supported by productivity of labor growth. To keep their profit margins, entrepreneurs raise prices, resulting in inflation and convergence of price levels (Janáčková 2000; Jonáš 1998).

.....

In 1993, the price level increased again, mainly in reaction to the new tax system and due to the monetary separation of Slovakia (Slaný 2003). Myant maintains that after the introduction of VAT, prices immediately shot up by 8.5 percent, although the system was set up not to have any influence on the price levels (Myant 2003). However, enterprises jumped at the opportunity to increase prices. Besides, a lot of market subjects misunderstood the functioning of the system after its launching.

From 1994 to 1998, the monthly growth of prices dropped to less than 1 percent and it stagnated on this level for the entire era (for causes of this phenomenon see BOX 38).

BOX 38 Steady inflation

.....

I discussed the steady (nondropping) inflation and the problems it caused the central bank in Chapter 4. This was due to increasing amounts of money in circulation—that is, monetary aggregates. Also, the central bank did not succeed in (especially in 1994 and 1995) maintaining the growth of monetary aggregate M2 in the planned interval (see Table 5.9).²¹ Yet Klaus maintained that the M2 growth in this period was fully acceptable, because the number of economic subjects was growing, monetization of the economy was increasing, and there were more financial transactions and large transfers of property, which led to an increase of transaction numbers and faster money turnover (Klaus 1994).

Table 5.9: The central bank targets and the real development of M2 and inflation, 1993–1997

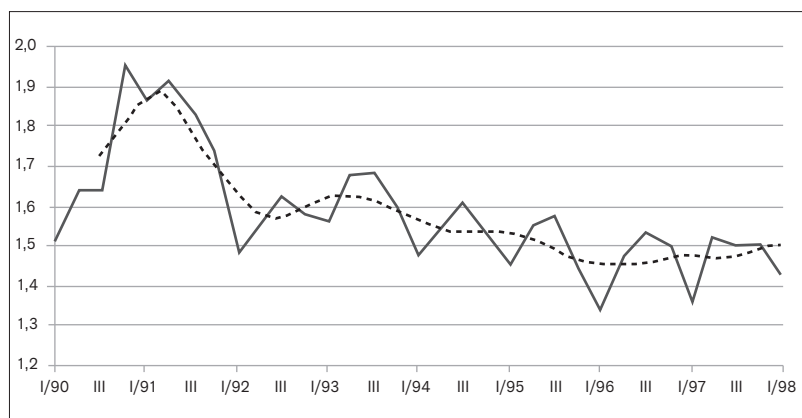
	Targeted growth of M2 (in %)	Real development	Operation criterion	CPI prognosis and reality (in parentheses) in %
1993	16 ± 1	21	monetary base	15 (18)
1994	13.5 ± 1.5	22	monetary base	10 (10)
1995	15.5 ± 1.5	19	monetary base	9 (8)
1996	15 ± 2	8	2T REPO rate	9 (9)
1997	10 ± 2	10	2T REPO rate	8 (10)

Source: Hampl (2001).

One of the main causes of the growth of the amount of money in the economy was the inflow of foreign capital (e.g., Kvizda in Dobešová et al. 2003).²² Because of this, we have to include among the indirect causes of inflation the fixed exchange rate, which was important for capital inflow (Jonáš 1997). And the interest rate differential, which was both the cause and the consequence of inflation (Slaný 2003).

There was another problem, even if the central bank was able to keep the growth of M2 in its planned interval. The problem was in a highly unstable nature of the velocity of the M2 turnover. In order to use M2 as an anchor of the whole system, it would be necessary to be able to reasonably estimate the development of this value. As Figure 5.13 shows, it was highly volatile during the whole transformation period.

Figure 5.13: Turnover velocity of M2, 1990–1998



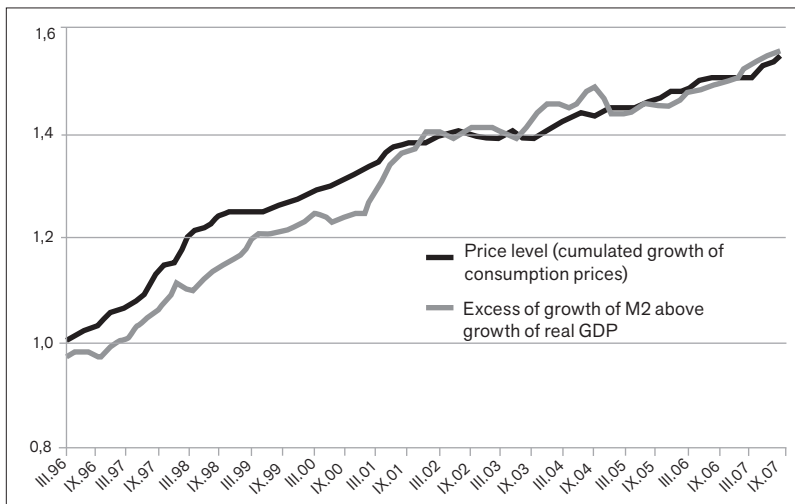
Source: Ministerstvo financí ČR (2002).

Even if velocity was changing, in the long run inflation was mainly caused by growth in money in circulation (see Figure 5.14). I do not need to mention that the results are in accordance with the quantitative theory of money.

There are other causes of inflation. First, I should mention the ongoing, albeit slow, price deregulations. Prices that were not fully liberalized in January 1991 (e.g., electricity, gas, rent, telecommunications) were gradually deregulated later. Some authors mention high growth of wages compared to productivity of labor (Jonáš 1997; Tomeš 2000). Tomeš blames structural imbalances in the economy, which resulted in weak downward flexibility of prices. Klaus

saw the main cause in inertial inflation—lasting inflation expectations (around 10 percent [Klaus 1995; see also Hampl 2001]). These expectations played a role in wage negotiations. Others drew attention to the effects of convergence with the price level in advanced countries. There was a wide gap between the price level in the CR and the EU²³ and the higher price growth in the CR can be explained as a manifestation of their convergence (Janáčková 2000). This growth was also occurring vicariously through import prices (Myant 2003). Another factor was the Balassa-Samuelson effect. Holman points out one more aspect of the price growth—the quality amelioration was not (probably) taken into account in the growing price indexes, and so the real inflation was lower than the official numbers (Holman 2000).

Figure 5.14: Growth in price level and excess of growth of M2 above growth of real GDP, 1996–2007



Source: Tomšík (2008).

After 1997, price level was influenced by an economic recession and a strict monetary policy. The price growth rate started to drop in 1997—from 13.4 percent in January to 6.8 percent in December. This development became even more apparent the next year, when inflation targeting was introduced. I have already mentioned the quick disinflation that followed after the introduction of inflation targeting. I said the central bank was permanently undershooting

its inflation targets. Net inflation decreased in 1998 from 7.9 percent in February to 1.7 percent in December. In this context, Klaus writes about leap disinflation, which brought high economic costs (Klaus 2000). Low inflation at the end of the decade was also influenced by lower world prices of food and slower price deregulations. The cause was that the deregulation process was nearing its end and prices approximated the world prices (see Table 5.10).

Table 5.10: Number of goods with administered prices in the European Bank for Reconstruction and Development (EBRD)-15 basket

1989–1990	1991	1992–1996	1997–2002	2003–2004
15	9	4	2	1

Source: EBRD (2008).

The outcome of relatively low inflation pressures in the first transformation decade was that the price increase in the Czech Republic was the lowest of all post-socialist countries, as shown in the table below. From another point of view, the price growth was ten times higher than in Austria (see Table 5.11).

Table 5.11: Comparison of inflation in the CR, selected transition economies (1989 = 100)

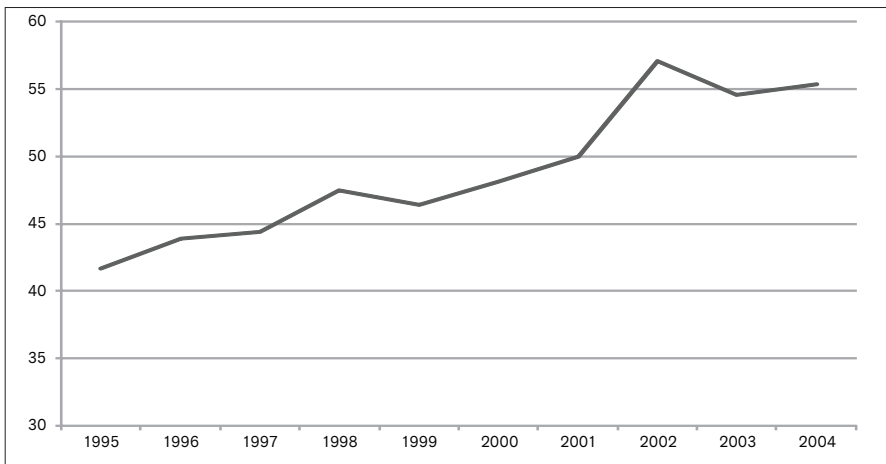
	1990	1991	1992	1995	1997	2000	2002	2004
Bulgaria	100	434	789	4,341	114,410	154,751	175,923	190,982
Rumania	100	270	839	9,353	33,077	111,816	184,164	237,609
Czech Republic	100	152	169	246	290	341	364	374
Hungary	100	135	166	310	453	625	719	804
Poland	100	170	244	557	767	1,013	1,089	1,136
Slovakia	100	161	177	272	306	404	448	522

Sources: EBRD (2008).

After 2000, disinflation continued with minor fluctuations. For example in 2001, the price level increased by 4.7 percent, mainly due to deregulations of rent, electricity, gas, transport, postal service, and telecommunications (*HN 2002 Yearbook* 2002). Growth of food prices was also an important factor (Janáček and Zamrazilová 2002). In 2002, the combined effect of weak demand, a strong exchange rate, and low global prices of raw materials resulted in the lowest rate of inflation since the start of transformation—consumer prices increased by 1.8 percent (Janáček and Zamrazilová 2003). The record was broken the next year when the price level increased by only 0.1 percent,

partly because price deregulations came to a halt and import prices dropped (due to the strengthening of the exchange rate against the dollar by 14 percent). Janáček and Zamrazilová maintain that the prices of consumer goods decreased primarily due to competition among the newly established chain stores (Janáček and Zamrazilová 2004). However, prices of services were growing. Overall, the price level in the Czech Republic was catching up, albeit slowly, with the price level in the EU, as is evident from Figure 5.15.

Figure 5.15: Price level of final consumption by private households in the Czech Republic (EU 27 = 100)



Source: Eurostat (2012).

We can consider an interesting comparison of individual prices during the whole transformation period. The development of prices of the selected goods is depicted in Table 5.12. One of the columns shows changes in the price level between 1991 and 1989 and another shows the same changes but for the whole period from 1989 to 2004. We can recognize goods whose prices increased more or less than average inflation. In the longer run, foremost prices of services increased above the average pace. Prices of several imported commodities—coffee or tea—grew slowly or even declined in the period. Prices of durables—fridges, washing machines, or cars—grew less than average inflation. This evidence is in accordance with economic theory. Prices of services should increase in the long run and prices of tradable goods should be relatively stable because of international competition.

Table 5.12: Inflation, cumulative growth in price level, and growth of prices of selected goods, 1989–2004 (average price at the end of the year)

Commodity	Amount	1989	1990	1991	Change 1991/1989
Inflation rate in %		1.4	9.7	56.6	
Cumulated change (1989 = 100)			109.7	166.7	1.7
Bread	1 kg	2.80	4.40	6.59	2.4
Potatoes	1 kg	1.60	3.30	3.96	2.5
Fresh butter	1 kg	40.00	67.20	80.62	2.0
Milk	1 l	2.00	3.60	6.29	3.1
Eidam cheese	1 kg	23.00	42.64	66.49	2.9
Coffee	100 g	24.00	18.00	19.40	0.8
Tea chopped	100 g	40.00	40.00	49.60	1.2
Bottled beer 10°	0,5 l	2.50	2.50	4.04	1.6
Rum (Czech)	1 l	100.00	100.00	104.78	1.0
Coffee in restaurant	1 portion	3.35	3.40	3.88	1.2
Black coal	100 kg	39.40	30.00	92.76	2.4
Man's suit	1 piece	966	1,240	1 871	1.9
Man's shoes	1 pair	348	351	601	1.7
Fridge	1 piece	5,780	5,720	12,230	2.1
Automatic washing machine	1 piece	5,950	6,068	9,589	1.6
Škoda car	1 piece	84 600	97 208	127 223	1.5
Petrol - 91 special	1 l	8.00	16.00	16.00	2.0
Individual ticket in public transport	1 piece	1.00	1.00	2.88	2.9
Stamp for letter within CR	1 piece	1.00	1.00	1.00	1.0
Man's haircut	1 operation	7.00	7.15	10.73	1.5
Ticket to the cinema	1 piece	7.33	6.89	10.73	1.5
Disposal of rubbish	per year	61	64	199	3.2

Commodity	Amount	1995	2000	2004	Change 1989/2004
Inflation rate in %		9.1	3.9	2.8	
Cumulated change (1989 = 100)		245.9	359.7	399.5	4.0
Bread	1 kg	11.29	14.80	15.25	5.4
Potatoes	1 kg	9.70	7.02	6.61	4.1
Fresh butter	1 kg	92.44	91.00	115.48	2.9
Milk	1 l	9.63	12.54	14.35	7.2
Eidam cheese	1 kg	99.10	112.12	114.06	5.0
Coffee	100 g	23.48	11.92	6.49	0.3
Tea chopped	100 g	24.70	38.80	42.53	1.1
Bottled beer 10°	0,5 l	6.19	7.61	8.48	3.4
Rum (Czech)	1 l	138.59	165.49	176.65	1.8
Coffee in restaurant	1 portion	8.12	11.56	15.47	4.6
Black coal	100 kg	171.51	264.45	387.96	9.8
Man's suit	1 piece	3,527	4,943	4,923	5.1
Man's shoes	1 pair	980	1,327	1,389	4.0
Fridge	1 piece	8,498	9,885	8,254	1.4
Automatic washing machine	1 piece	13,334	13,920	11,468	1.9
Škoda car	1 piece	223 187	229 521	262 900	3.1
Petrol - 91 special	1 l	19.05	28.21	25.78	3.2
Individual ticket in public transport	1 piece	4.46	6.96	7.30	7.3
Stamp for letter within CR	1 piece	3.60	5.40	6.50	6.5
Man's haircut	1 operation	24.74	41.89	65.43	9.3
Ticket to the cinema	1 piece	28.03	60.21	76.25	10.4
Disposal of rubbish	per year	810	1,252	1,368	22.3

Source: ČSÚ (2011).

Notes

- ¹ Borensztein, Demakas, and Ostry ascribe this production slump to the situation in which neither the plan nor the markets functioned, while the state-owned enterprises were neither controlled, nor enticed to act market-wise (Borensztein, Demakas, and Ostry 1995).
- ² The data are for the entire federation and therefore influenced by the lower satisfaction of Slovak citizens. For example, in the spring of 1992, data for the CR were as follows: positive 70.8 percent, neutral 20.1 percent, negative 9.1 percent; and for SR: positive 58.2 percent, neutral 28.9 percent, negative 12.9 percent (Koutníková 1992).
- ³ In real numbers the volume of loans between 1991 and 1990 decreased by 29 percent (Myant 2003).
- ⁴ In the initial years, this involved primarily unsophisticated production, such as raw materials and semifinished products (Myant 2003).
- ⁵ He also mentioned an enormous increase in the price of oil – only recently we paid 800 CSK per ton of crude oil, while today (January 1991) we pay 4 500 CSK (Klaus, 1991).
- ⁶ For example Borensztein, Demakas and Ostry (1995) mention that the standard index numbers will tend to overestimate production slump after price liberalization.
- ⁷ It can be assumed that the satisfaction in the CR was higher than in the SR. In spring 1992, CR data were as follows: positive—25.1 percent, neutral 47.8 percent, negative 27.1 percent, while SR: positive 17.8 percent, neutral 52.6 percent, negative 29.6 percent (Koutníková, 1992).
- ⁸ Myant (2003) maintains that interest rates on deposits in the CR between 1993 and 1997 oscillated around 7 percent. In Britain it was lower than 4 percent and in Germany rarely over 4 percent.
- ⁹ Similarly Mach writes that the roots of recession were in the system of fixed exchange rate and foreign exchange operations (Mach 2000).
- ¹⁰ Besides, the author believes that the monetary policy of the central bank was too restrictive, but the CNB was not the sole culprit.
- ¹¹ For a deeper analysis of individual opinions regarding the crisis, see Loužek (1999).
- ¹² Klaus's "plot" hypothesis appears to be an unproven (and improvable) conspiracy theory.
- ¹³ Despite this growth, the 1990 level of industrial production was not reached yet, mainly due to the loss of markets in Russia (*HN 2004 Yearbook* 2004).
- ¹⁴ Even if there are significant doubts about the measurement of grey economy in transformation (Hanousek and Palda 2006).

- ¹⁵ Over 50 percent of workforce in the Czech Republic had college level or high school education. The same index in Poland and Hungary was 30–40 percent (Jírová 2001).
- ¹⁶ The number of employed seniors decreased from 466,000 to 162,000 between 1990 and 1992. This was a direct result of government policy, for example doubling of income tax for retired seniors between 1991 and 1992 (Jírová 2001). Tens of thousands of elderly people retired earlier and disability pensions were also granted more liberally (Kaiser 1995).
- ¹⁷ Some authors claim that the government is responsible for this development, because it exerted pressure on banks to borrow money to enterprises.
- ¹⁸ For example in January 1999, the highest unemployment was in the Most region—16.5 percent and the lowest in eastern Prague—1.8 percent (*HN 2000 Yearbook* 2000).
- ¹⁹ Myant maintains that 220,000 foreigners lived in the CR legally in 2000, while he estimates the number of illegally employed people to 140,000 (Myant 2003).
- ²⁰ According to the December 1990 poll, people expected the total price growth to be around 80 percent, but they were negatively surprised even by the substantially lower numbers—60 percent of Czechs and 72 percent of Slovaks. People with elementary education were surprised the most (74 percent), college educated people less (52 percent), and highly qualified professionals the least (38 percent) (Miková 1992).
- ²¹ Opinions concerning the importance of aggregates vary. Myant carried out econometric analysis and he claims that during the 1990s, the relation between aggregates and inflation was weak, while the relation to price deregulations was strong (see Myant 2003).
- ²² The reason for steady inflation lied in the balance of payments surplus, which led to the growth of monetary aggregates (Sommer 1995). The government (for purely political reasons) was not willing to solve the surplus by revaluation and the author thus perceived the lasting inflation as a result of forced choice between lower growth and increase of price level.
- ²³ The price level represented one-third of Austrian and German price level (Hanousek and Krkoška 1997).

EXTERNAL BALANCE

In our analysis of the basic macroeconomic results, I have the last part to discuss—outer relationships. This chapter analyzes all aspects of such relationships—trade, movement of capital, and migration. First, I deal with the development of foreign trade. It is one of the most important parts of outside relationships and therefore I devote a significant part of this chapter to this topic. Then, I concentrate on the other subaccounts of the current account. Next, I turn to the financial account, followed by the summary of the development of the balance of payments and foreign reserves. I conclude the chapter with the discussion of international integration on the labor market—migration from and into the Czech Republic.

6.1 Foreign trade

This section presents the condition of Czechoslovak foreign trade at the end of the 1980s; as well as the process of trade liberalization and further the development of foreign trade in the 1990s. The final subchapter compares the situation at the beginning and the end of the decade.

6.1.1 Situation before 1989

Czechoslovak foreign trade was based on export and import plans, like other parts of the economy. The trade itself was carried out by foreign trade enterprises. In 1990, there were only fifty-two enterprises that did business with foreign companies in the entire Czechoslovakia (Dillon and Wykoff

2002). Domestic prices were distorted by subsidies, taxes and exchange rates and therefore in no relation to global prices.

Most of the trade was directed eastwards—some estimate it at approximately 60–80 percent. The share of western countries on the Czechoslovak trade was estimated at approximately 20 percent (Jonáš, 1997). Products with relatively higher added value were sold in the east. On the contrary, the producers were able to sell to the west mostly only raw materials or semi-manufactured goods—it means that it was mainly goods with lower added value that headed to the west. The situation in imports was quite the opposite—the country imported technological devices and commodities with high added value from the west, and mostly raw materials from the east. The economy was relatively closed. For example Michal (1994) mentions that the export to GDP ratio in 1987 was only 19.4 percent.

It should be ascribed to the positives points of the previous regime that its representatives did not allow any substantial imbalance in foreign trade (or in the balance of payments) to develop. On the other hand, the offer of western products on the Czechoslovak market in the 1980s was incomparably worse than for example in Hungary.

Czechoslovakia's position in the heart of Europe (with long borders with Germany and Austria) was considered by some to be its long-term asset (e.g., Krkoška 1999; Švejnar 1997). It seemed to be a promising feature for the future development of foreign trading and other economic relations with the western world.¹ These contacts hastened the economic re-integration of the country into the global economy in the years to come. It presented a relative advantage for Czechoslovakia compared to countries located east of it (Švejnar 2002).²

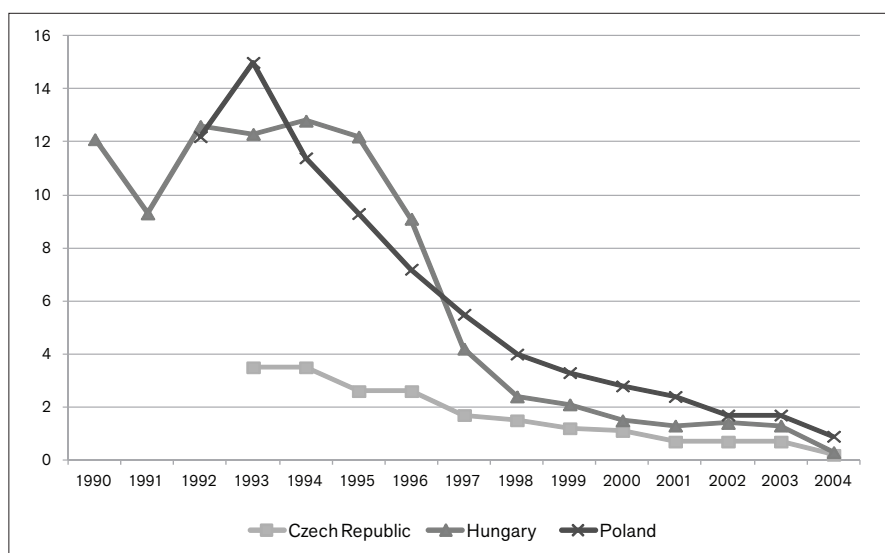
6.1.2 Liberalization and subsequent development

In the initial two years of transformation, all basic measures for the liberalization of foreign trade were taken. The currency was devaluated in 1990, which created the exchange rate cushion. Private entrepreneurship was legalized and thus the monopoly of foreign trade enterprises disappeared. Crucial changes were implemented in 1991. On January 1, the crown became internally convertible. The fixed exchange rate stabilized international relationships in the following years. Export duties were decreased to the average value of 5 percent (Jonáš 1997).³ The government (concerned about

the balance of payments stability) imposed 20 percent import surcharge. The surcharge was fairly quickly decreased as it turned out that foreign currency was not draining from the country.⁴ The surcharge was a measure taken to evade breaking the GATT (General Agreement on Tariffs and Trade) rules, but Czechoslovakia had to make a new custom's tariff while it was in force. This modified tariff meant a moderate growth of average duties to 5.7 percent (Hoen 1998; Plchová 2001).

By the end of 1991, the association treaty with the EC was signed—the so-called European treaty. It involved the asymmetric liberalization. The European Community removed barriers for 70 percent of Czechoslovak imports and the rest was liberalized within five to six years. Conversely, Czechoslovakia freed only 20–25 percent of imports and the rest was planned to be liberalized within nine years (Lavigne 1999).⁵ The longest deadline was defined for the most problematic items.

Figure 6.1: Tariff revenues in Central European countries, 1990–2004 (% of imports)



Source: EBRD (2007).

This liberalization was in line with the general trend of weakening domestic market protection after the end of the Uruguay round of GATT negotiations in 1993. At this time, Czech customs tariffs were already lower than the OECD average (Plchová 2001). Other protectionist measures such as quotas and

licenses were used only for specific commodities such as drugs and weapons. In December 1994, the CR joined the World Trade Organization (WTO). Customs policy remained liberal (see Figure 6.1), even in comparison with other transforming countries.

The institutional state support for exporters was minimal because the government was not inclined to intervene in the market system. The only exception was the establishing of Export, Guarantee and Insurance Corporation (EGAP) in 1992 (see BOX 39).

BOX 39 EGAP

Export, Guarantee and Insurance Corporation (EGAP) is a loan insurance company focusing on insuring loan risks related to exports on products and services from the Czech Republic. EGAP provides insurance services to all exporters of Czech products regardless of their size, legal status, or exported volume. EGAP insures against consequences of political, financial, or the macroeconomic situation. It was founded in July 1992 and it is a joint-stock company, fully owned by the state (www.egap.cz).

Since the beginning of transformation, foreign trade began changing its orientation from eastern to western markets, primarily due to disintegration of eastern markets (the CMEA was disbanded in 1991). The strong impact of the disintegration on the Czech economy is depicted in Table 6.1.⁶

Table 6.1: Export to CMEA countries (in millions of USD)

	1989	1990	1991	1992	1993	% decline between 1989 and 1993
the CR*	5,103	3,422	2,045	1,103	1,009	80.2
Bulgaria	7,967	5,887	1,892	1,103	1,009	87.3
Hungary	4,009	2,933	2,710	2,981	3,122	22.1
Poland	4,395	4,000	1,799	1,476	1,461	66.8
Romania	3,890	2,083	1,089	702	720	81.5
Slovakia	1,827	1,169	1,376	1,200	1,130	38.1

*without the trade between the CR and Slovakia

Source: Jonáš (1997).

The following factors played a major role: necessity to pay in convertible currencies; rapidly worsening exchange relations in the trade with the former USSR countries; transformation recession in other former centrally planned economies; and demand for western products in those countries. Central

European leaders signed the Central European Free Trade Agreement (CEFTA) in 1992 to counterbalance this trend but the impact of the agreement was limited. Besides, little knowledge of western markets, combined with protectionist measures, limited the chances of Czech exports—for example the first attempt at introducing antidumping measures against Czech steel manufacturers dates back to 1992 (Myant 2003).⁷

The largest percentage of imported commodity structure consisted in machinery, vehicles, industrial and final products. However, the share of these sophisticated products in Czech exports dropped at the expense of raw materials, fuels, and semifinished products (see Figure 6.8).

Essential changes in the foreign trade occurred in the initial years of transformation and the subsequent development was not so dramatic anymore. In 1993, Czechoslovakia disintegrated and thus the foreign trade formally increased, but in reality, part of the internal trade was simply reclassified as foreign. As a result, Czech exports grew by 25 percent and imports by approximately 21 percent. However, the new border limited the mutual exchange of merchandise, in spite of the customs union and the clearing account trading (see BOX 40).

BOX 40 Customs union of the CR and the SR

One of the areas where the division of Czechoslovakia had a negative impact was the decline in trade exchange with Slovakia. Mutual dependence before the division was strong—Czech exporters sold approximately 12–15 percent of the industrial production to Slovakia, while the Slovaks exported 26 to 32 percent (Soukup 1995). Mutual trade had been declining since the beginning of the decade, but it plummeted directly after the disintegration and the mutual exchange dropped to 70–75 percent of the previous volume (Sekera and Klvačová 1994). However, this result was better than the pessimistic forecasts (of up to a 50 percent drop). The situation improved in 1993, but the drop at the end of the year was still striking—approximately 16 percent (Žahour 1994). This drop could have been even higher, had it not been for the clearing account and the customs union. The customs union is a form of international integration bloc with no mutual trade barriers and unified customs tariff toward non-member countries. The trading union agreement was signed in October 1992 and it did not officially come into force before May 3, 1993, but it was temporarily in force since January 1. Another reason for the customs union—in addition to the effort to prevent a foreign trade slump—was an association treaty with

the EC. There were worries of having to renegotiate the conditions of the treaty that was considered favorable (Soukup 1995). The customs union demonstrated that the EC may deal with both of the successional countries as one subject and there is no need to negotiate again. This strategy proved to be successful, association treaty conditions did not change in the economic area and the new treaty was signed in October 1994.

Agreements between the CR and the SR included a special clearing regime making it possible to pay in home currencies—that is without the pressure on foreign currency reserves. The exchange rate between Czech and Slovak currencies was calculated from their exchange rates against freely convertible currencies. Import-to-export surpluses were limited and the exceeding amounts had to be paid in foreign currencies (CNB 2003).

The customs union was plagued by permanent disputes and that critical voices were a daily matter as early as 1994 (Soukup 1995). The Czechs criticized the Slovaks for exceeding the limit of the clearing account system twice, for requiring food import certificates (including Czech food) and for introducing a 10 percent import surcharge, while the Slovaks complained of insufficient legislative harmonization of foreign trade. Although these issues escalated several times, the agreement lasted until both countries joined the EU, when it naturally expired. Its existence, together with the clearing system, probably improved mutual trade, but could not prevent the share of Slovakia in the Czech trade exchange from dropping, and vice versa.

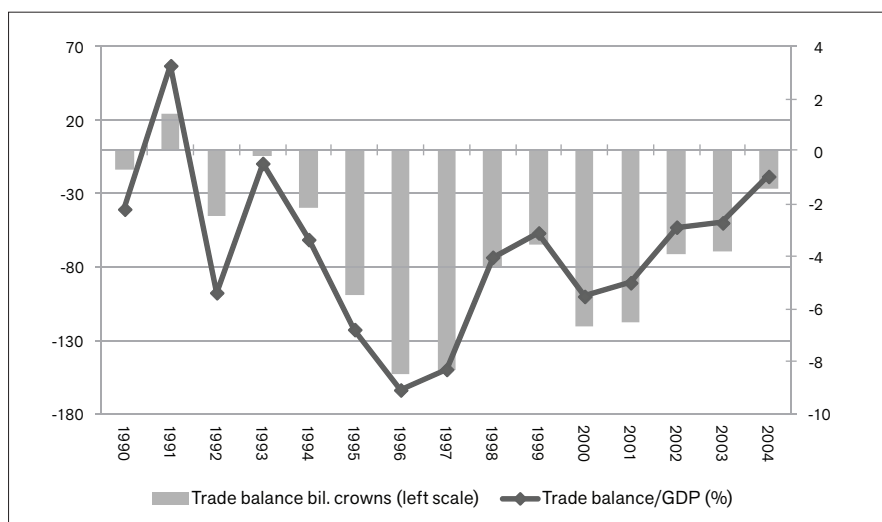
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In the mid-1990s, increasing foreign trade imbalance became a dominant factor. In 1995, the trade balance deficit exceeded 7 percent of GDP and the deficit of current account in the balance of payments exceeded 2.6 percent of GDP (ČSÚ 2003; see also BOX 41). State support for exporters was boosted by the founding of the Czech Export Bank. Its task is to grant loans at favorable interest rates to exporters. The bank focuses on long-term transactions—export of machinery and investment units.

In 1996, the external imbalance further deepened. Exports increased by 6.3 percent, compared to 13.4 percent growth of imports. The current account deficit amounted to 7.1 percent of GDP (ČSÚ 2003)—see BOX 41. Inflow of capital could not balance the deficit and therefore foreign currency reserves decreased. These problems led to the 1997 currency crisis. Since the second quarter—after the crisis and currency devaluation—exports began to grow rapidly, while imports increased only moderately. As

a result, the current account deficit decreased, despite the negative impacts of the crisis in southeastern Asia and later in Russia. In 1998 and 1999, both the trade balance and the current account in the balance of payments were consolidated. For example, the volume of exports increased by almost 17.6 percent, while imports increased by only 6.5 percent in 1998. See Figure 6.2 for trade balance.

Figure 6.2: Balance of trade in billions of crowns and as a share of GDP between 1990 and 2004 (in %)



Source: ČSÚ, Statistical Yearbooks (1995, 2005).

The deficits started to grow in subsequent years, but it was not because of internal economic imbalance, rather because of growing prices of crude oil; sometimes because of depreciation of the currency against the dollar; and for example in 2002 due to floods that led to weaker tourism and worse balance of services. However, generally speaking, the foreign trade and current account imbalances did not arouse such fears as before 1997.⁸

BOX 41 Current account deficit

In 1995 and 1996, the Czech Republic suffered from a considerable current account deficit in the balance of payments. It became a subject of numerous expert discussions and the deficit became one of the reasons of stricter monetary policy in mid-1996 and of the currency crisis in May 1997 (Dědek

2000). The government did not perceive the deficit to be a long-term threat (e.g., Hájek 1997), partly because it was primarily commodities necessary for restructuring that were imported, such as machinery and equipment.

The current account deficit may occur for various reasons. Most economists ascribed the Czech deficit either to insufficient domestic supply⁹ that could not satisfy the demand and therefore it was satisfied from abroad (e.g., Sojka 2000), or to excessive investment. As the volume of savings in the country was not sufficient (although relatively ample), foreign capital started to flow in, resulting in a deficit on the current account in the balance of payments (e.g., Klaus 2000).

Table 6.2: The share of the current account balance to GDP, 1990–2004 (in %)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic						-2.5	-6.7	-6.3	-2.1	-2.4	-4.7	-5.3	-5.7	-6.3	-5.3
Hungary	1.1	1.2	0.9	-10.8	-9.5	-3.6	-3.8	-4.3	-7.0	-7.7	-8.5	-6.0	-7.0	-8.0	-8.4
Poland	1.9	-0.4	1.0	-1.3	5.3	0.6	-2.1	-3.7	-4.0	-7.4	-6.0	-3.1	-2.8	-2.5	-4.0

Source: IMF (2010).

The current account deficit in general is not necessarily dangerous or unhealthy. If a country suffers from the current account deficit, it simply testifies to the approach of the domestic market subjects to contemporary consumption, for which they essentially borrow money from abroad (in the form of foreign capital inflow). The current account deficit becomes a problem if it grows too high,¹⁰ or if it is not covered by inflow of foreign capital and investors start to fear currency devaluation—which is essentially a market solution to the deficit. Currency devaluation represents a loss for investors and they will try to avoid it by diverting their money abroad—exactly the situation that occurred in the CR. Table 6.2 demonstrates that the Czech deficit was not exceptional in the region in the 1990s. Most other countries had similar or higher, and often longer, deficits.

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6.1.3 Foreign trade development factors

What were the long-term factors influencing the development of foreign trade? The fixed exchange rate definitely played a stabilizing role since it was introduced in 1991, providing companies with anchor for their transactions. Conversely, permanent real appreciation of the crown due to higher inflation (than the trade partners) was negative for exporters and positive for importers. The development of the exchange rate between the dollar and the German mark also played its role. After 1997, the nominal exchange rate's development became an important foreign trade factor. Terms of trade, that shows the ratio between export and import prices, also played a significant role in the entire period. Export prices in most of the years increased more than import prices (see Figure 6.3).

Figure 6.3: Indexes of export and import prices; terms of trade (1991 = 100)



Source: Hájek (1997).

Czech exporters had the advantage of relatively low labor expenses compared to advanced western economies. And there was without any doubt an increase in quality of the Czech production, partly as a consequence of a huge inflow of foreign direct investment into the country. Manufacturers in both advanced and developing countries began to defend themselves against Czech exports by using for example antidumping measures. Investigations and proceedings applied against the Czech Republic are presented in Table 6.3.

Table 6.3: Number of antidumping investigations and proceedings, 1995–2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
AD against the Czech Republic										
AD investigation	1	1	0	2	7	3	2	1	1	0
AD proceeding	1	1	1	0	1	4	1	3	1	1
AD the Czech incentive										
AD investigation	0	0	0	2	1	0	0	0	0	0
AD proceeding	0	0	0	0	0	1	0	0	0	0

Source: WTO (2006).

The membership of the CR in international organizations played a positive role in foreign trade. These included the WTO and CEFTA agreement with the European Free Trade Association in 1992,¹¹ and the association treaty with the EC.

Obviously, economic conditions of the main foreign partners also played a significant role in the development of Czech exports—stronger economies in these countries meant stronger demand for Czech products. If the German economy grew, Czech exports grew as well. The same applies of course to the relation between imports and the development of the domestic economy. Growing Czech GDP meant higher imports. The economy was increasingly integrated into the world economy but at the same time more dependent on foreign economies, especially on European ones. See Table 6.4 for the overall development of the foreign trade.

Table 6.4: Basic Czech foreign trade statistics, 1990–2004

	Export mld. CSK/CZK	Import mld. CSK/CZK	Balance mld. CSK/CZK	Turnover mld. CSK/CZK	Change EX %	Change IM %	Change turnover %	GDP mld. CSK/CZK
1990	162.5	176.2	-13.7	338.7				626.2
1991	233.6	208.8	24.8	442.4	43.8	18.5	30.6	753.8
1992	248.1	293.4	-45.3	541.5	6.2	40.5	22.4	842.6
1993	421.6	426.1	-4.5	847.7	69.9	45.2	56.5	1,020.3
1994	458.8	498.4	-39.6	957.2	8.8	17.0	12.9	1,182.8
1995	566.2	665.8	-99.6	1,232.0	23.4	33.6	28.7	1,466.7
1996	601.7	754.7	-153.0	1,356.4	6.3	13.4	10.1	1,660.6

	Export mld. CSK/CZK	Import mld. CSK/CZK	Balance mld. CSK/CZK	Turnover mld. CSK/CZK	Change EX %	Change IM %	Change turnover %	GDP mld. CSK/CZK
1997	709.3	859.7	-150.4	1,569.0	17.9	13.9	15.7	1,785.1
1998	834.2	914.5	-80.3	1,748.7	17.6	6.4	11.5	1,962.5
1999	908.8	973.2	-64.4	1,882.0	8.9	6.4	7.6	2,041.4
2000	1,121.1	1,241.9	-120.8	2,363.0	23.4	27.6	25.6	2,150.1
2001	1,269.6	1,386.4	-116.8	2,656.0	13.2	11.6	12.4	2,315.3
2002	1,250.4	1,325.3	-74.9	2,575.7	-1.5	-4.4	-3.0	2,414.7
2003	1,371.0	1,441.0	-70.0	2,812.0	9.6	8.7	9.2	2,532.4
2004	1,722.7	1,749.1	-26.4	3,471.8	25.7	21.4	23.5	2,577.1

	EX/GDP %	IM/GDP %	Turn/GDP %	Balance TB/ GDP %	CA mld CSK/ CZK	CA/GDP %
1990	26.0	28.1	54.1	-2.2		
1991	31.0	27.7	58.7	3.3		
1992	29.4	34.8	64.3	-5.4		
1993	41.3	41.8	83.1	-0.4	13.3	1.3
1994	38.8	42.1	80.9	-3.3	-22.6	-1.9
1995	38.6	45.4	84.0	-6.8	-36.3	-2.5
1996	36.2	45.4	81.7	-9.2	-111.9	-6.7
1997	39.7	48.2	87.9	-8.4	-113.0	-6.3
1998	42.5	46.6	89.1	-4.1	-40.5	-2.1
1999	44.5	47.7	92.2	-3.2	-50.6	-2.5
2000	52.1	57.8	109.9	-5.6	-104.9	-4.9
2001	54.8	59.9	114.7	-5.0	-124.5	-5.4
2002	51.8	54.9	106.7	-3.1	-136.4	-5.6
2003	54.1	56.9	111.0	-2.8	-160.6	-6.3
2004	66.8	67.9	134.7	-1.0	-143.3	-5.6

Note: 1990–1992 trade excluding Slovakia

Source: ČSÚ (2005, 2005) and author's own calculations.

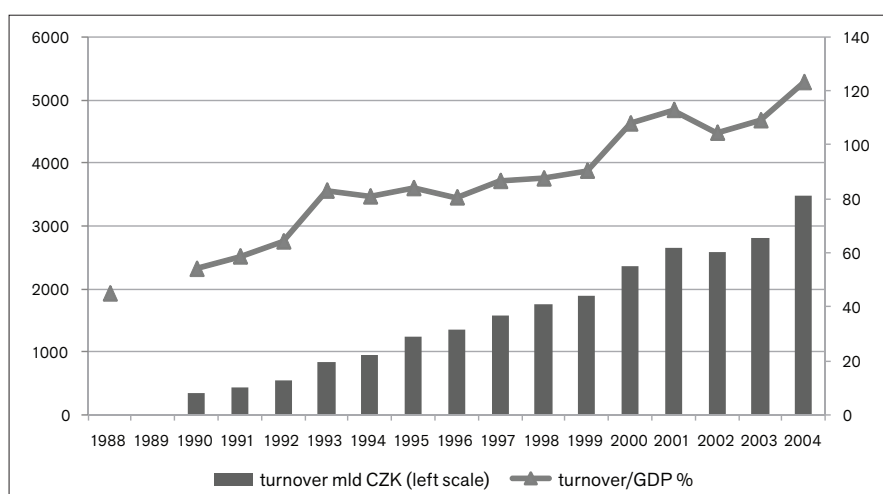
6.1.4 Changes in foreign trade

I now discuss the fundamental changes in the character of foreign trade that took place during transformation, namely in trade volume, its territorial and commodity structure.

During the 1990s, the trade volume increased substantially. As is shown in Figure 6.4, the Czech trade volume increased from 339 billion CSK in 1990 to

over 2,800 billion CZK in 2003 (ČSÚ 2003). Similar trend is visible in the turnover to GDP ratio, which increased from 54 percent in 1990 to 111 percent in 2003. But the results of both indexes are influenced by the disintegration of Czechoslovakia and the resulting nominal trade increase, as can be seen in the graph. Czech economy is currently one of the most open economies (turnover/GDP) in the world and its openness is on par with similarly sized western economies.¹² Consequently, the economy became highly dependent on economic partners abroad.

Figure 6.4: Czech foreign trade turnover, 1989–2004 (in million CSK/CZK, as GDP %)



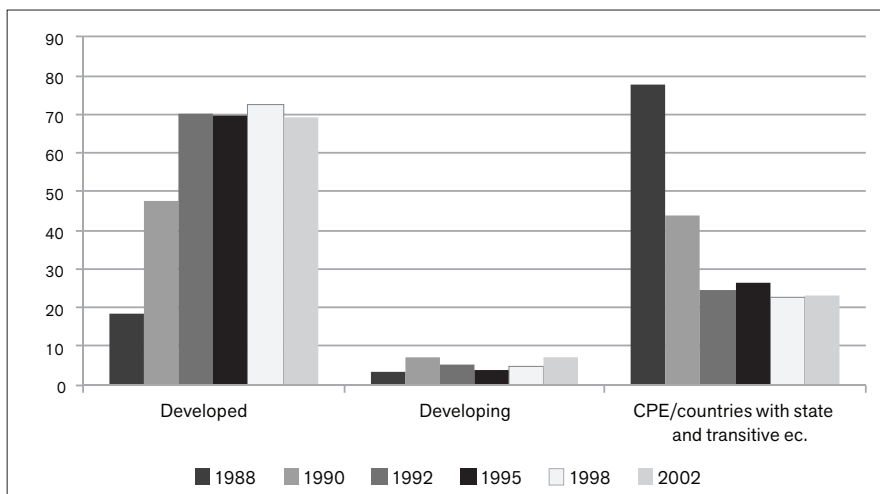
Source: ČSÚ (1991, 1995, 2005).

In the course of the decade, the territorial structure of the Czech trade changed as well, from eastern to western markets. It occurred shortly after 1990, as the share of advanced countries increased while the share of European countries with transitive economies decreased (Figures 6.5 and 6.6). Partial changes involve steady growth of imports from other transitive economies, mainly from China.

It is clear from Figure 6.6 that the share of advanced economies in Czech exports since 1992 oscillates around 70 percent. For a specific direction of trade to individual countries see Table 6.5.

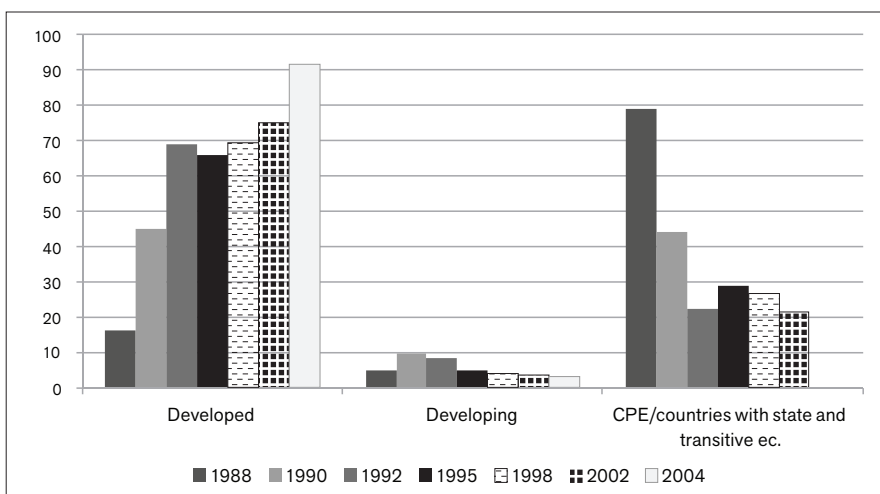
Note the positive trade balance with neighboring countries and the fact that the greatest deficit was with Russia due to imports of raw materials, namely crude oil.

Figure 6.5: Territorial structure of imports to the CR, 1988–2004 (in %)



Source: ČSÚ (1993, 2005).

Figure 6.6: Territorial structure of exports from the CR, 1988–2004 (in %)



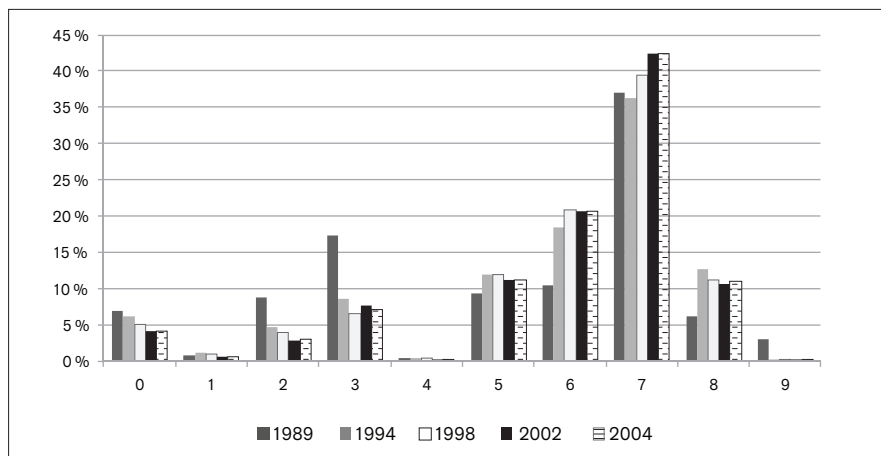
Source: ČSÚ (1993, 2005).

Table 6.5: Main trade partners in 2000

	turnover		export		import		balance
	(millions of CZK)	%	(millions of CZK)	%	(millions of CZK)	%	(millions of CZK)
Germany	855,486	36.1	452,923	40.4	402,563	32.3	50,360
Slovenia	160,822	6.8	86,081	7.7	74,741	6.0	11,340
Austria	128,352	5.4	66,933	6.0	61,419	4.9	5,514
Italy	106,620	4.5	42,389	3.8	64,231	5.1	-21,842
Poland	105,318	4.4	60,935	5.4	44,383	3.6	16,552
France	106,775	4.5	45,108	4.0	61,667	4.9	-16,559
UK	99,471	4.2	48,055	4.3	51,416	4.1	-3,361
Russia	95,160	4.0	14,920	1.3	80,240	6.4	-65,320
United States	86,510	3.7	31,560	2.8	54,950	4.4	-23,390
Holland	54,840	2.3	25,780	2.3	29,060	2.3	-3,280
Belgium	51,835	2.2	24,435	2.2	27,400	2.2	-2,965
Spain	40,870	1.7	18,098	1.6	22,772	1.8	-4,674

Source: Ministry of Industry and Trade (2001).

Figure 6.7: Commodity structure of Czech imports, percentage of individual groups according to SITC, 1989–2004



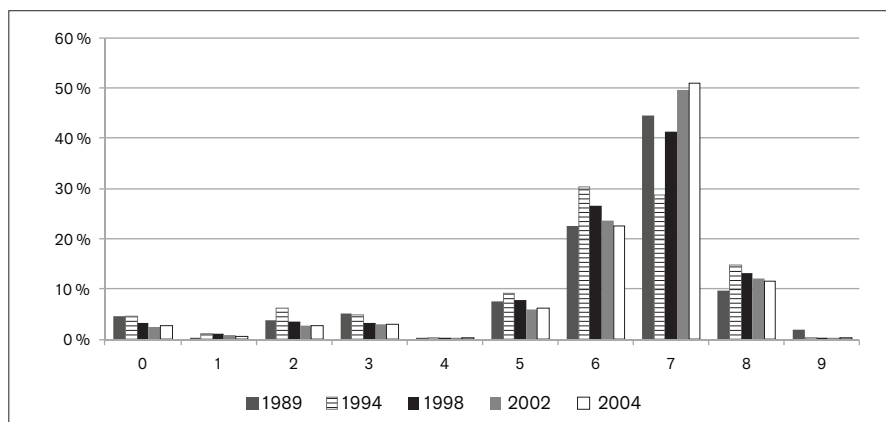
Source: ČSÚ (2003).

In the course of transformation, commodity structure of trade changed substantially. SITC (Standard International Trade Classification)¹³ is used to classify the commodity structure of imports and exports. Generally speaking, groups 0, 1, 4, and 8 are parts of personal consumption. Raw materials, fuels, and semifinished products—that is production commodities—are in groups 2, 3, 5, and 6. Group 7 includes machines and vehicles. Figure 6.7 reveals the trend of decreasing share of consumption and production, excluding semifinished products in Czech imports. By contrast, the share of imported machinery and vehicles was growing. This group constituted the largest portion of Czech imports.

The structure of Czech exports developed in a much more interesting way. The trend of dropping shares of machinery and equipment (traditional components in Czech exports) in the first phase of transformation until 1994 is apparent. This development was a consequence of the reorientation of Czech trade due to its inability to export commodities with high added value to advanced markets, and concurrent drop in the demand for Czech products in the former centrally planned economies. Consequently, exports of relatively less sophisticated commodities—raw and semifinished materials—increased. In the mid-1990s, Czech export returned to its traditional structure, the share of machinery increased and it was even higher than in 1989 (see Figure 6.8).

The development of Czech trade is in my point of view one of the greatest achievements of the whole transformation process. I should mention that at the beginning of the 1990s the economy was closed and almost completely orientated toward the eastern markets. The cause was poor quality of production; otherwise the communist regime would have been glad to export more to the west. By the middle of the first decade of the twenty-first century, the Czech economy was fully integrated into the world economy with total majority of exports going to demanding western markets. At the same time, exports were mostly created by machinery and vehicles—goods with higher added value. This is indirect evidence that the quality of Czech production improved enormously during the period. Conversely, there are pros and cons of the high economic dependence. Growing economies of the trading partners have a stimulating effect on the Czech economy (e.g., Fitzová and Židek 2015). But the economy can be negatively affected if the economies of the foreign partners fall into crisis.

Figure 6.8: Commodity structure of Czech exports, percentage of individual groups according to SITC, 1989–2004



Source: ČSÚ (1993, 2005).

6.2 Other items on the current account

I now turn to other items on the current account in the balance of payments—the balance of services, the balance of revenues, and of current transfers. For the theory of balance of payment see BOX 42.

6.2.1 Balance of services

Throughout its existence, the Czech Republic had a surplus in the balance of services. Since the mid-1990s, this asset amounted to approximately 50 billion crowns and covered a major part of the trade balance deficit. The main components in the revenues part of the balance include tourism and transport, especially of natural gas (Tomšík 2002). Worsening of the balance in 2002 must be ascribed to weaker tourism as a direct consequence of floods (Janáček and Zamrazilová 2003). As Table 6.6 shows, the trend continued in the following two years. In 2003, for example, active balance amounted to only 13.2 billion CZK. It was mainly revenues itemized as “other services” that declined, while transport and tourism remained the same, concluding that the worsening in 2002 was only partially caused by floods (Janáček and Zamrazilová 2004).

Table 6.6: Balance of services (in billions of CZK)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Balance	29.5	14.0	48.9	52.2	55.9	62.0	41.5	54.6	58.0	21.8	13.2	12.4
Revenues	137.7	148.4	178.3	222	227.2	246.7	243.9	264.8	269.7	231.1	219.2	248.4
Expenses	108.2	134.4	129.4	169.8	171.3	184.7	202.4	210.2	211.7	209.3	206.0	236.0

Source: CNB (2005).

BOX 42 The balance of payments theory

The balance of payments is one of the main macroeconomic indicators. Its accounts aggregate all across-the-border transactions. The Czech Statistical Office website (www.czso.cz/csu) provided the following definition:¹⁴

The balance of payments is a statistical statement, which records (in a systematic way) economic transactions with abroad (i.e., between residents and non-residents) for a certain period of time. The basic structure of the balance of payments that ensues from the *IMF Balance of Payments Manual* (5th edition, 1993) includes the current, the capital and the financial accounts, change in foreign exchange reserves.

The current account records the flow of goods (export and import) and services (income and expenses from transport services, travel and other commercial and noncommercial services), income from capital, investments and labor (interest, dividends, reinvested profits, earned income) and the balancing items for the real and financial resources provided or acquired without counter-value (current unilateral transfers, such as gifts, alimonies, pensions, foreign aid).

The capital account consists of transfers of capital character connected with the migration of the population, remission of debts, ownership rights to fixed assets (for example investment grants) and transfers of not manufactured, non-financial tangible assets (for example land—representations sites) and intangible rights (patents, licenses, copyrights, and so on).¹⁵

The financial account includes transactions connected with the rise, extinction and change in ownership of the financial assets and liabilities of the government, the banking and corporate spheres and other entities in relation to abroad. It provides information on the financial (capital) flows in the break-down into direct investments (registered capital and other capital), portfolio investments of equity and debt character, financial derivatives and other investments, broken down into long-term and short-term and by the basic sectors (the CNB, commercial banks, the government,

and other sectors), under which fall supplier and bank credits, loans, deposits, participations in international non-monetary organizations et alia.

Foreign exchange reserves represent foreign assets of the CNB (deposits in foreign banks, credits granted, stock of foreign securities, bullion and foreign currencies, SDR, reserve position with the IMF), which can be readily mobilized above all as a source of direct financing of the payment disequilibrium and of indirect regulation of this disequilibrium by means of interventions on the foreign exchange market.

Errors and omissions are a balancing item intended as an offset to the understatement or overstatement of the current, capital and financial balances on the one hand and the change of foreign exchange reserves on the other. They represent a balance of unidentified flows in the current, capital and financial account.

The balance of payments is balanced by definition—by changes in foreign currency reserves. However, the deficit in the balance of payments is a widely used term (including this book). It basically means that foreign currency reserves flowed out of the country.

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6.2.2 Balance of revenues

Another component on the current account in the balance of payments is revenues. Transactions figured in this account include revenues from two production factors—labor and capital, including for example payment of interests, salaries of foreign employees (and Czech employees abroad), payment of dividends. Capital revenues are classified to revenues from direct, portfolio, and other investments. Table 6.7 shows that the CR had a permanently negative balance of revenues, increasing during the 1990s—principally due to increasing payments to foreign employees and profits, dividends,

Table 6.7: Balance of revenues (in billions of CZK)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Balance	-3.4	-0.6	-2.8	-19.6	-25.1	-35.1	-46.7	-53.0	-83.5	-115.6	-119.9	-139.5
Revenues	16.0	22.7	31.7	31.8	44.7	55.0	64.3	75.4	84.9	66.8	75.5	70.2
Expenses	19.4	23.3	34.5	51.4	69.8	90.1	111.0	128.4	168.4	182.4	195.4	209.7

Source: CNB (2005).

and interests sent abroad (Tomšík 2002). Outgoing revenues from foreign direct investments, consisting of reinvested profits and repatriated dividends, play an ever increasing role (more on this in, for example, Novotný 2004).¹⁶

6.2.3 Current transfers

The last component, which had a relatively minor influence on the development of the current account in the balance of payments, involves current transfers. This account includes financial transactions of citizens, such as gifts, alimonies, or pensions, but also government transactions, such as transfers of money within the framework of the PHARE (Poland and Hungary Aid for Economic Restructuring) program. The impact of current transfers account was permanently positive throughout the 1990s (see Table 6.8).

Table 6.8: Balance of current transfers (in billions of CZK)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Balance	2.5	3.6	15.2	10.5	11.3	16.7	20.4	14.4	17.8	28.7	15.8	6.1
Revenues	7.0	8.5	17.6	16.8	27.4	34.6	45.4	36.6	36.4	46.7	47.0	46.0
Expenses	4.5	4.9	2.4	6.3	16.1	17.9	25.0	22.2	18.6	18.0	31.2	39.9

Source: CNB (2005).

6.3 Financial account

The other main component in the balance of payments is the financial account. In the chapter, I will first discuss its general development, then foreign direct investments (as its most important part) and finally the other components of the financial account.

The financial account between 1990 and 1992 was practically balanced. In 1993, the first surpluses turned up on the account, culminating in 1995. I have already discussed the causes of this foreign capital inflow. Briefly summed up: quick economic growth and the resulting high confidence of foreign investors; macroeconomic and political stability; cheap labor and suitable geographic location; higher interest rates than abroad, combined with fixed exchange rate; liberalization of capital transfers in 1995—convertible

currency; and domestic demand for capital—enterprises and banks received foreign loans.

I have already mentioned the issue of the foreign capital's temporary character—the fact that a major part of the incoming capital in the mid 1990s was short term. However, since 1995, the share of the long-term resources—especially foreign direct investments (FDI) due to privatization of Czech enterprises—and long-term loans to enterprises and Czech banks have been growing. Another essential aspect in the development of the balance of payments was the broadening of the fluctuation band of the crown in 1996, which contributed to the outflow of short-term capital and the consequent deficit in the entire balance of payments (first since the founding of the CR). The capital outflow was also in the core of currency turbulences in the following year. After 1998, FDI inflow became apparent, while it was only partially balanced by the outflow in the other components of the financial account in the balance of payments. For the financial account's development, see Table 6.12.

6.3.1 Foreign direct investment

Foreign direct investment is an important component in capital movement. Many authors analyze its mostly positive impact on the economy (see BOX 43).

BOX 43 Importance of FDI for transformation

Foreign direct investment is defined—in accordance with the IMF—as investments of foreign investors into Czech enterprises and companies that represent at least 10 percent of the basic capital or at least 10 percent of the voting rights. Another condition is a permanent interest of the investor to control the company. But the foreign company does not necessarily have to control the enterprise or own a majority share.

Positive aspects of FDI include creation of new jobs, import of modern technologies, better management and know-how, which should eventually lead to faster economic growth (Jahn 2002). In case of transforming economies, FDI hastens their restructuring. It can also be expected that the products from new companies will be sold on foreign markets, resulting in better trade balance in the long run.

However, not all impacts of FDI are positive. In the short run, capital inflows exert pressure on the strengthening of exchange rate, causing problems for exporters (Klaus 2002). Other impacts on the payment balance are not necessarily positive either. Investments are often accompanied by import of investment units, a burden for the trade balance (Tomšík 2002). Besides, companies will later repatriate profits from their investment, bringing about negative impact on the balance of revenues (developments in the CR and in Hungary testify to this trend). And some scholars point out the danger of the so-called dual economy, with flourishing foreign and dying domestic enterprises (Tomšík 2002).

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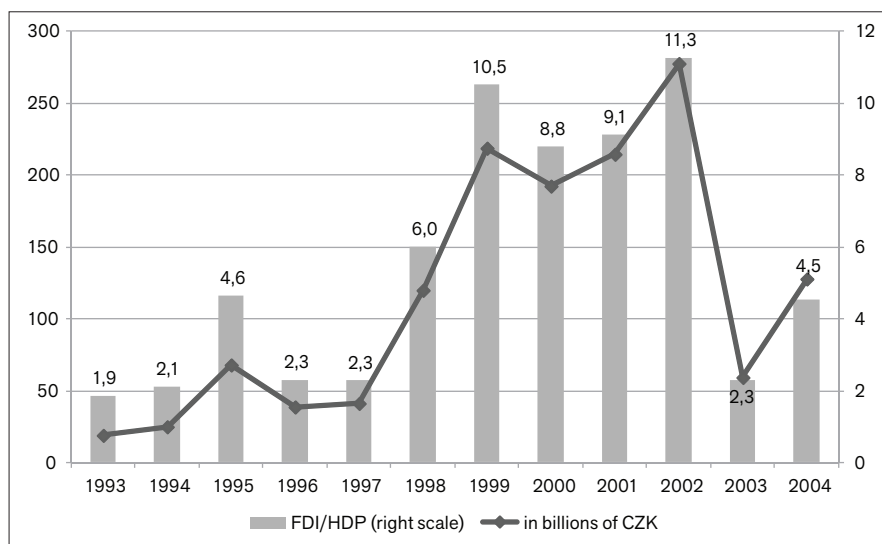
The attitude of Czech governments toward foreign investments was ambiguous. On the one hand, there was a clear need for foreign capital, know-how, and management. On the other, politicians were afraid of cheap sale of Czech assets to foreign hands.¹⁷ Right-center governments were also skeptical toward special conditions for foreign investors. Inflow of FDI during transformation oscillated (depending significantly on privatization), but it increased substantially after 1998.

At the end of the decade, such factors as macroeconomic stability, chance to buy assets relatively cheap after currency devaluation, and strengthening of investment incentives in 1998 (see BOX 45—and Jahn 2002) and activity of CzechInvest came into play (see BOX 44). The inflow of foreign direct investments to the CR is shown in Figure 6.9.¹⁸

The total amount of FDI in the Czech economy at the end of 2003 amounted to 1.2 trillion CZK (51 percent of GDP), with negligible direct Czech investments abroad. The balance of other investment position components (portfolio and other investments) did not by any means reach such significant values (Novotný 2004). There were 55,000 companies with foreign share in the CR, with 1,200 production facilities (CzechInvest 2003). The group of biggest foreign investors included such enterprises as TelSource, Telefonica (Czech Telecom), Volkswagen (Škoda Auto), Philip Morris (Tabák Kutná Hora), ABB, Continental, Daewoo, Danone, Ford, Matsushita, Nestlé, Procter & Gamble, Renault, and Siemens. The largest recent foreign direct investment was a car manufacturing plant in Kolín worth 1.5 billion CZK by Toyota and PSA Peugeot Citroën. The main branch attracting foreign investment is services (54 percent of the total amount before 2002), represented by mainly financial mediation, transport, telecommunications, trade and repairs. Another essential branch is industry (44 percent of the total amount), especially manufacturing industry

(approx. 36 percent), with the largest share of automotive industry and production of chemical, rubber, and plastic products (Novotný 2004).

Figure 6.9: Net inflow of foreign direct investments to the Czech Republic, 1993–2004
(in billions of CZK and as % of GDP)



Source: CNB (2005).

BOX 44 CzechInvest

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CzechInvest agency was founded in 1992, with the aim to promote Czech Republic as an ideal place for foreign investment and to support inflow of foreign direct investment into the country. In 2004, the agency merged with the Agency for Development of Business (ARP) and with the Agency for Development of Industry (CzechIndustry). The mission of the new CzechInvest is to support competitiveness of Czech entrepreneurs, especially processing industry and innovations (e.g., incubators, scientific-technological park). CzechInvest contributes to advance domestic companies and the creation of new firms through its services, development programs, and to improve the business environment. It is the exclusive receiver of applications for granting investment incentives and its task remains to lure foreign direct investments to the CR. CzechInvest is an allowance organization funded by Czech Ministry of industry and trade (www.czechinvest.cz).

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At the end of 2001, subsidiaries of foreign companies were estimated to account for 70 percent of Czech manufacturing industry exports and directly employed 280,000 people. 10,000 Czech companies in manufacturing and services collaborated with them, employing at least 500,000 more people (*HN 2002 Yearbook 2002*).

BOX 45 Investment incentives and FDI

Investment incentives were introduced by the Miloš Zeman's government in April 1998.¹⁹ Both domestic and foreign subjects were entitled to apply. Nevertheless, the minimum investment (25 million dollars, later decreased) was so high that the chances of domestic companies to get hold of these incentives were significantly limited (and indeed, very few did get them). Incentives involve tax allowances (up to ten years for new enterprises); grants for creation of new jobs; grants for training and retraining of employees; providing infrastructure for construction sites; discounts on sale of state-owned land; faster depreciation; zero duty on imported technologies; and construction of infrastructure (for example highways). Other criteria require that the investment goes into production (at least 50 percent of the machines must be on the government-approved list of hi-tech machinery); the plant must be brand new or modernized; investment must be covered by property, and so on (more at www.cezchinvest.cz).

Investment incentives (and the activity of CzechInvest) are among the most controversial topics of economic policy. Klaus's governments refused global incentives and Klaus himself has criticized them sharply (for example, Klaus 2002). He claims that incentives are not an important factor in corporate decision-making. However, the investors claim the opposite—"and they would have been stupid if they did otherwise" (Klaus 2002). Klaus poses another important question, namely why the incentives are limited by the investment size when no theory has ever proven that large investments are more beneficial than small investments. He believes the reasoning behind incentives is purely political. For example Kinkor is also a sharp opponent of incentives (Kinkor 2002). The agency is often criticized by Klaus, and also by Kulháněk (cited in Pohanka 2003), who uses the example of Koh-I-Noor, that CzechInvest attracts foreign investment at any price,²⁰ resulting in market distortions. Negative aspects of the incentives became apparent for example in the infamous Flextronics investment in Brno—the company made maximum profit and left the country.

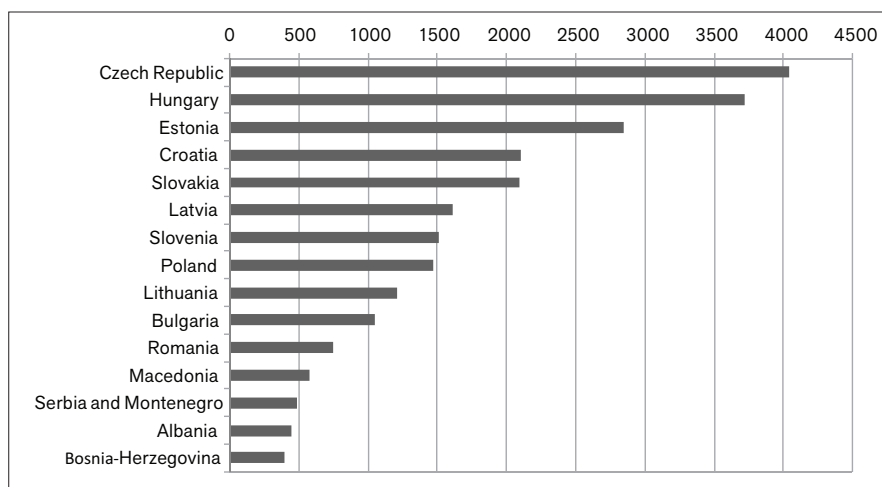
Representatives of CzechInvest view the incentives and the agency activities positively, claiming that it is a crucial factor in the inflow of FDI to the country. Jahn for example claims that investment incentives before 2002 brought foreign investments in the amount of 3.4 billion dollars and created at least 27,000 new jobs (Jahn 2002). He also claims that at least 70 percent of that investment would go elsewhere without it. But he fails to prove the statement.

Jahn argues that the CR must provide incentives, because other countries do so as well (Jahn 2002). He also claims that without the incentives the CR would lose its favorable position. Klaus believes that good business environment, including low taxes, is the best incentive of all (Klaus 2002).

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During the transformation period, the Czech Republic attracted the highest volume of foreign direct investment per capita in the end (see Figure 6.10). Generally, the positive attitude toward the Czech economy can be seen in the development of the country's rating (see BOX 46).

Figure 6.10: Cumulative FDI inflows per capita, 1989–2004 (in USD)



Source: Berend (2009).

BOX 46 Rating

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The rating agencies were intensively criticized during the last financial crisis at the end of the first decade of the twenty-first century. But we can anyway

consider their rating as a clue for foreign investment in individual countries at minimum because at present we do not have any better tool. There are three main rating agencies in the present world economy. Their scales of investment rating are listed in Table 6.9.

Table 6.9: Long-term rating scales of the main rating agencies

Moody's	S&P	Fitch	
Aaa	AAA	AAA	Prime
Aa1	AA+	AA+	
Aa2	AA	AA	High grade
Aa3	AA-	AA-	
A1	A+	A+	
A2	A	A	Upper medium grade
A3	A-	A-	
Baa1	BBB+	BBB+	
Baa2	BBB	BBB	Lower medium grade
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	
Ba2	BB	BB	Noninvestment grade speculative
Ba3	BB-	BB-	
B1	B+	B+	
B2	B	B	Highly speculative
B3	B-	B-	
Caa1	CCC+		Substantial risks
Caa2	CCC		Extremely speculative
Caa3	CCC-	CCC	
Ca	CC		In default with little prospect for recovery
	C		
C		DDD	
/	D	DD	In default
/		D	

Source: www.wikipedia.org.

The rating is mainly used for sovereign debts—it means that the value evaluates respective countries and their credits. Credits of companies/banks are evaluated individually but usually in connection with the rating for the sovereign debts. The rating of Czech government credits was improving during the transformation process. And even the 1997 currency crisis had only a limited impact on the view of the rating agencies to the ability of the Czech government to pay its debts, as can be seen in Table 6.10.

Table 6.10: Foreign currency long-term sovereign debt ratings

	Moody's	Standard and Poor's	Fitch
1992	Ba1	—	—
1993	Baa3	BBB	—
1994	Baa2	BBB+	—
1995	Baa1	A	A-
1996	Baa1	A	A-
1997	Baa1	A	BBB+
1998	Baa1	A-	BBB+
1999	Baa1	A-	BBB+
2000	Baa1	A-	BBB+
2001	Baa1	A-	BBB+
2002	A1	A-	BBB+
2003	A1	A-	A-
2004	A1	A-	A-

Source: ČNB (2012).

Foreign direct investment between 1993 and 2004 came mainly from Germany, the Netherlands, and Austria—investors from these three countries accounted for over 50 percent of all FDI in the country (see Table 6.11).

Table 6.11: Territorial structure of FDI in the CR,
according to the country of origin, 1993–2004
(in millions of USD and percentage)

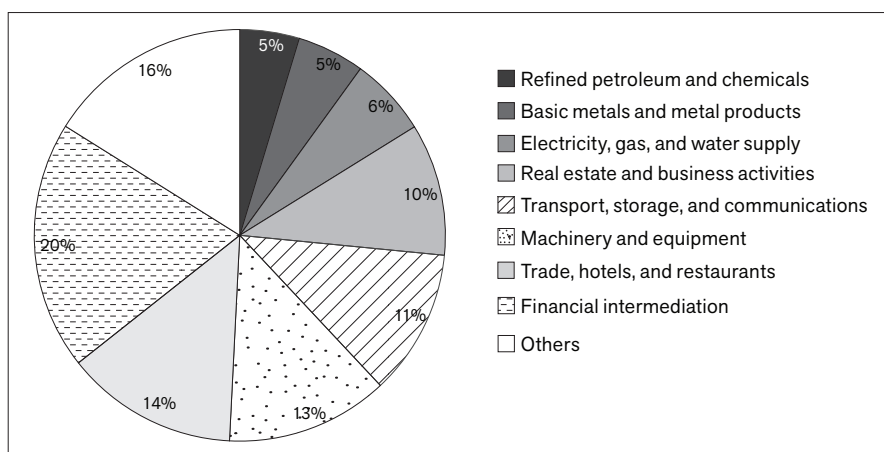
	Million USD	%
Germany	12,173	28
Netherlands*	7,293	17
Austria	4,460	10
United States	3,258	8
France	3,193	7
Switzerland	2,295	5
Belgium	1,974	5
United Kingdom	1,848	4
Japan	641	1
Other	5,905	14
Total	43,041	100

* Data for the Netherlands is often distorted, because many multinational companies have their residence in the country.

Source: ČNB (2012).

We can consider another interesting aspect of FDI—its direction according to sectors. The general division of FDI is between the manufacturing and the nonmanufacturing sectors. Surprisingly, most of the incoming cumulative FDI went to the nonmanufacturing—67 percent and only the remaining 33 percent was targeted at the manufacturing sector between 1993 and 2004. The main division of FDI among the individual sectors can be seen in Figure 6.11. The highest percentage of FDI was invested by foreigners in the financial intermediation sector (20 percent). It was followed by trade, hotel, and restaurant sector (14 percent), and machinery and equipment (13 percent).

Figure 6.11: Inflow of FDI into the Czech economy, according to sectors, 1993–2004



Source: ČNB (2012).

It is also quite interesting to follow the development of direct Czech investment abroad. These investments are still small in volume, especially in comparison to incoming FDI. The reasons lie in the state of the Czech economy. Czech companies during transformation were undercapitalized and did not have enough resources to invest abroad. The overall outflow reached USD 2.3 billion between 1993 and 2004 (www.oecd.org/investment/statistics, 26. 7. 2012). Out of this, one billion dollars was invested by Czech companies in 2004 alone—it was mainly caused by the purchase of electricity distribution companies in Bulgaria by the energy giant ČEZ. Bohatá and Zemplerová (2004) mention that 360 Czech enterprises invested abroad until 2002. Three-quarters of these investments came from small- and mid-size companies and 80 percent went to services.

6.3.2 Other components of the financial account

Finally I would like to shortly discuss other components in the financial account of the balance of payments.²¹ I shortly describe the development of the portfolio, short- and long-term accounts. Numeric data summing up the development of these accounts are shown in Table 6.12.

Fluctuations in some segments of portfolio investments resulted from the fluctuation in purchasing of bonds by foreign investors. In 1996, for example, foreign interest in Czech securities decreased, resulting in lower inflow of portfolio investments (Myant 2003). Their ensuing inflow was related to purchasing bonds. In 1999 and 2000, purchasing foreign bonds by domestic subject turned up on the account—it was a period of strong growth on the US stock exchange. Portfolio investments also dropped because foreign investors partially withdrew after the Asian and the Russian crisis.

Movements of short-term capital are rather unsteady. High interest rate differential due to fixed exchange rate was a very important factor especially between 1993 and 1995. Once the fluctuation band was broadened in 1996, short-term capital flowed out. This trend became even more apparent the following year, when currency crisis hit the entire economy. After 1999, the outflow of capital was a consequence of lowered interest rate differential, which followed after lowering of domestic inflation.

The last and very important component in the financial account in the balance of payments is the movement of long-term capital. Its inflow, sometimes very conspicuous, is apparent between 1993 and 1997, and it consisted mainly in bank loans. Turnaround on this account occurred during economic recession. Demand for investments was declining; Czech banks had enough resources, but were paralyzed by the amount of classified loans. This made them more cautious while granting loans, and this is why they did not even need foreign resources.

6.4 Balance of payments: summary

The overall development of the balance of payments is summed up in Table 6.12. The balance was mostly positive, with the exception of 1996 and 1997.

The development of foreign currency reserves corresponds with the aforementioned trends. Between 1993 and 1995, the inflow of capital through

Table 6.12: Financial account and overall balance of payments in the CR, 1993–2004
(in billions of CZK)

	1993	1994	1995	1996	1997	1998
A. Current account	13.3	-22.6	-36.3	-111.9	-113.0	-40.5
B. Capital account	-16.2	0.0	0.2	0.0	0.3	0.1
C. Financial account	88.2	97.0	218.3	113.6	34.3	94.3
Direct investment	16.4	21.6	67.0	34.6	40.5	115.9
Portfolio investment	46.7	24.6	36.1	19.7	34.4	34.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	25.1	50.9	115.1	59.3	-40.6	-56.1
Assets	-83.9	-69.6	-66.1	-64.6	-142.7	-46.6
long-term	13.3	12.0	1.4	-10.8	-11.1	-24.3
short-term	-97.3	-81.6	-67.4	-53.9	-131.6	-22.3
Liabilities	109.0	120.5	181.2	123.9	102.2	-9.4
long-term	10.1	19.9	88.0	95.2	24.0	-39.8
short-term	98.9	100.6	93.2	28.7	78.1	30.4
D. Balance of errors and omissions, and differential exchange rate	3.0	-6.1	15.8	-24.2	22.4	8.7
Total A, B, C and D	88.3	68.3	197.9	-22.5	-56.0	62.6
E. Change in foreign currency reserves *	-88.3	-68.3	-197.9	22.5	56.0	-62.6

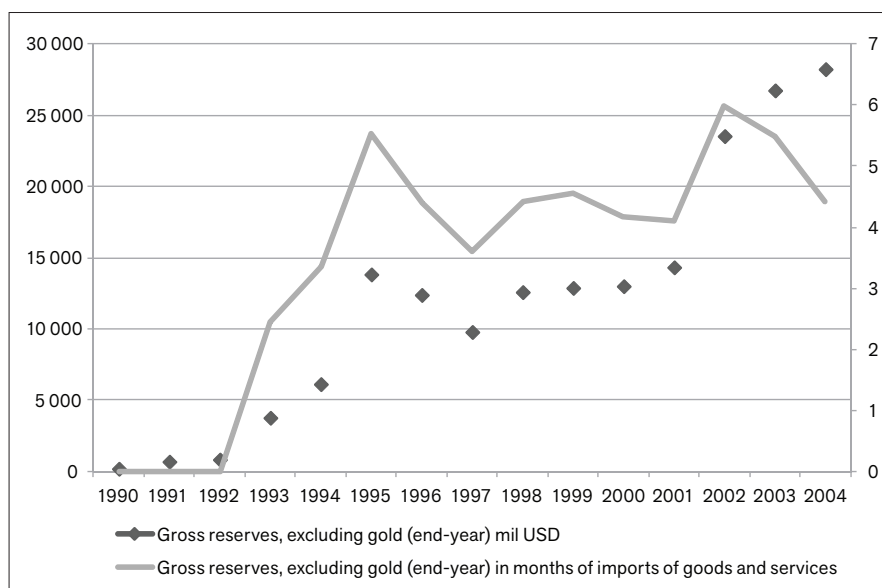
	1999	2000	2001	2002	2003	2004
A. Current account	-50.6	-104.9	-124.5	-136.4	-160.6	-143.3
B. Capital account	-0.1	-0.2	-0.3	-0.1	-0.1	-14.0
C. Financial account	106.6	148.0	172.8	347.8	157.1	180.9
Direct investment	215.7	190.8	208.3	270.9	53.5	100.7
Portfolio investment	-48.3	-68.2	34.9	-46.7	-35.7	62.2
Financial derivatives	0.0	-1.4	-3.2	-4.3	3.9	-1.5
Other investment	-60.9	26.9	-67.1	127.9	135.5	19.6
Assets	-91.3	35.8	-46.1	133.1	67.1	-36.0
long-term	-23.9	21.3	1.3	28.7	1.1	20.5
short-term	-67.4	14.5	-47.5	104.4	65.9	-56.5
Liabilities	30.4	-9.0	-20.9	-5.2	68.4	55.6
long-term	-1.3	-26.2	-4.3	2.9	26.4	29.8
short-term	31.7	17.2	-16.7	-8.0	42.0	25.8
D. Balance of errors and omissions, and differential exchange rate	1.2	-11.4	19.1	5.6	16.5	-16.9
Total A, B, C and D	57.1	31.6	67.2	216.9	12.9	6.8
E. Change in foreign currency reserves *	-57.1	-31.6	-67.2	-216.9	-12.9	-6.8

* – stands for growth of foreign exchange reserves.

Source: CNB (2005).

the financial account in the balance of payments was higher than the current account deficit, which meant increasing foreign currency reserves. In 1996 and especially in 1997, the Czech Republic suffered from the outflow of foreign reserves due to broadened fluctuation band of the crown and due to the monetary crisis. Since 1998, the reserves have been growing again as is shown in Figure 6.12.

Figure 6.12: Gross reserves in millions of USD and months of imports of goods and services covered by reserves, 1990–2004



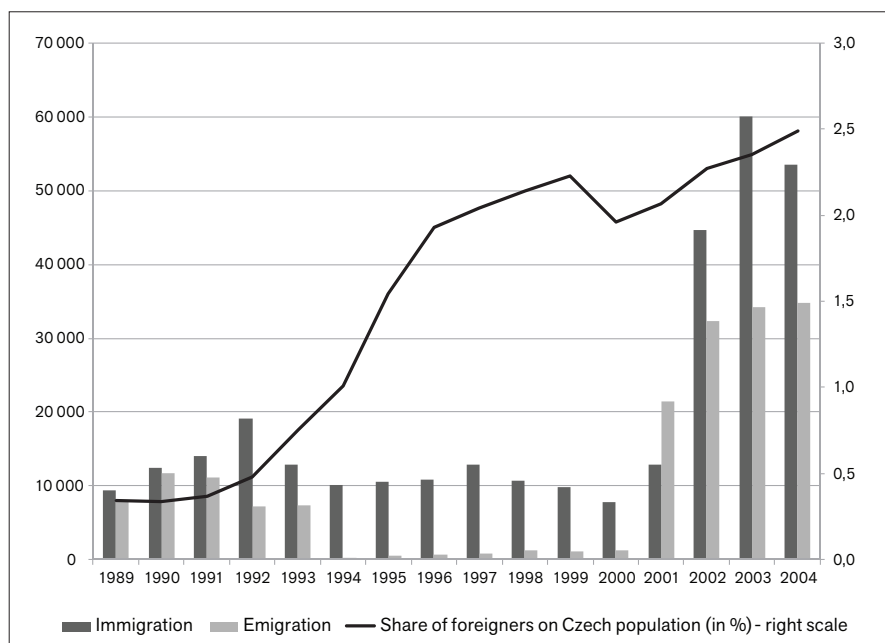
Source: EBRD (2007).

6.5 Migration

The third aspect of international relationships is the movement of labor force. There was continuous net growth of foreigners in Czech society during the transformation process. The only exception was 2001 when emigration exceeded immigration. Otherwise, we should notice that Czech citizens were leaving the country especially at the beginning of the 1990s and then at the beginning of the twenty-first century. Immigration was relatively stable until

2002 when it sharply increased. Regardless, immigrants account only for a small fraction of Czech population (Figure 6.13).

Figure 6.13: Emigration from and immigration into the Czech Republic and the share of foreigners in Czech population (in %)



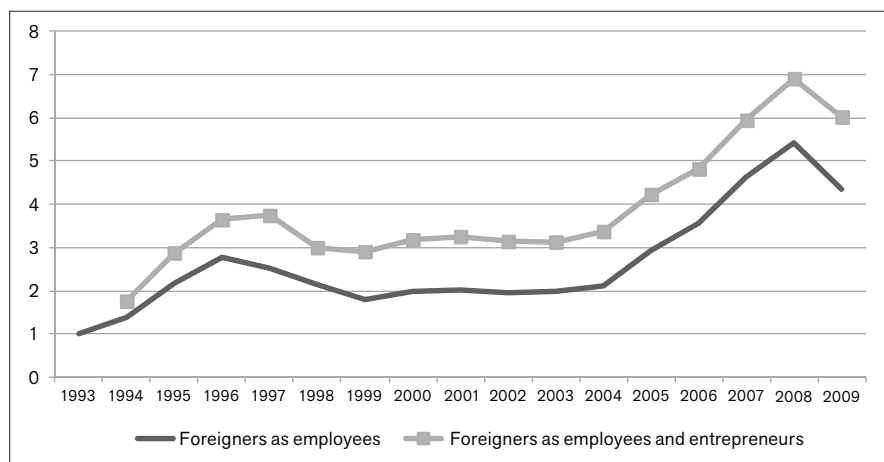
Source: ČSÚ (2011).

From the economic point of view, the share of foreigners in the Czech labor market is more important than the overall share of foreigners in Czech population. The share of foreigners on labor force was relatively low during the whole transformation period (see Figure 6.14). This share increased only after 2004. Foreigner workers probably did not have a negative impact on demand for Czech labor force (Pavel and Turkova 2007). But I should add that there are estimations of several hundred thousand illegal immigrants in the Czech labor market.

The last aspect of the labor market that needs to be discussed is remittances. They are often discussed as a relatively new economic phenomenon. Their importance for the Czech economy was limited because both inflow and outflow were just in terms of hundreds of millions of dollars. We can see the

development of inflow and outflow of remittances in Table 6.13; since 1996, outflow exceeded inflow. The average inflow reached 0.4 percent of GDP and outflow 0.8 percent of GDP. The maximum outflow in 2004 was roughly 1.3 percent of the Czech GDP.

Figure 6.14: Share of foreigners (employees and employees with entrepreneurs) in the Czech labor market, 1993–2009 (in %)²²



Source: Franc (2012).

Table 6.13: Inflow and outflow of remittances into and from the Czech Republic, 1993–2004 (in millions of USD)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Inflow	138	164	191	112	85	350	318	297	257	334	498	815
Outflow	6	55	101	303	341	745	642	605	718	898	1102	1431
Inflow-outflow	132	109	90	-191	-256	-395	-323	-308	-461	-563	-604	-617

Source: The World Bank (2011).

In this chapter, I discussed the development of foreign trade, capital movements, and migration. The data revealed that the international position of the economy totally changed during the period. The Czech economy became tightly integrated into the world economy and its progress since the early 1990s has been stunning. The development of international trade was especially interesting because the character of the economy has changed from a

closed economy orientated toward the eastern markets to an open economy with very strong and deep ties to developed markets. At the same time, export returned to goods with higher added value especially in the form of machinery and vehicles. This is in my view evidence of the successfulness of the whole transformation process. The second important aspect of the economic integration was inflow of foreign capital—especially in the form of FDI inflow into the economy. This inflow helped in the catching up process. As a consequence, the economy is now deeply integrated but at the same time it is vulnerable to shocks that come from abroad as well.

Notes

- ¹ Furthermore, Prague immediately became a favorite destination for western tourism.
- ² There are studies that attribute differences in unemployment rate between Czech and Slovak parts of the federation (in early stages of transformation) to the distance from the western border (Švejnar, Terrellová, and München 1997).
- ³ This liberalization was criticized by some authors (e.g., Pick 1994).
- ⁴ Jonáš mentions, that the 20 percent import surcharge was initially applied to most consumer goods (Jonáš 1997). It was decreased to 15 percent in midyear and abandoned in 1992.
- ⁵ After the European Council meeting in Copenhagen in 1993, liberalization on the part of the EU was further accelerated by one–two years (Soukup 1995). However, relations with the EU were not always problem-free. For example at the end of 1996, the Czech side introduced one-sided quotas in apple imports. In reaction, the EU introduced 100 percent duty on Czech pork, poultry, and apple juice. The Czech measure was canceled five months later, in April 1997 (Fawn 2000).
- ⁶ The CMEA disintegrated after Klaus' appearance at the meeting in Sophia in January 1990, in which he announced that Czechoslovakia would leave the organization (Myant 2003).
- ⁷ Domestic market protection in some countries was quite exceptional. Czechoslovak share on the US cheese market was just 0.007 percent, yet the Czechoslovak exports were limited by a quota (Klaus 1992).
- ⁸ After 2004, the trade balance shifted to surplus, but the current account stayed in deficit due to deficit in the balance of revenues.
- ⁹ Caused for example by overheating of the economy, wage growth exceeding work productivity growth, or inability to manufacture attractive products, and so on.
- ¹⁰ Economists have varying opinions, but they usually agree on the safe value of current account deficit up to 5 percent or 6 percent of GDP (see Table 4.11).
- ¹¹ This agreement liberalized approximately 80 percent of foreign trade, but did not involve agricultural commodities (Jirges and Plchová 1996).
- ¹² Czech Press Agency claimed on October 13, 2004 that with its share of imports and exports, the CR ranks among twelve most open economies in the world.
- ¹³ SITC classification groups are as follows: 0—food and animals; 1—drinks and tobacco; 2—raw materials, excluding fuels; 3—mineral fuels; 4—animal and plant fats; 5—chemicals; 6—intermediate products; 7—machinery and vehicles; 8—various industrial products; 9—other.
- ¹⁴ The reporting of the balance of payment has changed in 2013. The quoted system presented in the BOX was valid in the transformation period.

- ¹⁵ Capital account played practically no role in the development the balance of payments in the CR (see Table 6.12).
- ¹⁶ Reinvested profits are part of the current account (balance of revenues) and of the financial account (direct foreign investments). Reinvested profits, as defined in the methodology, increase the current account deficit although they do not in fact leave the country. This item does not therefore create pressure on external imbalance. However, in a longer time horizon, drop in reinvested profits and increase in repatriated dividends is a likely scenario (Novotný 2004).
- ¹⁷ Fawn for example mentions that Czech governments did not put up much effort to attract foreign capital (Fawn 2000). Klaus was fairly cautious of foreign capital, claiming that it cannot be expected to save our badly functioning enterprises (Klaus 1991).
- ¹⁸ Tomšík observes that the seasonal nature of the inflow, which is usually small in the beginning of the year, then it increases and it peaks at the end (Tomšík 2002).
- ¹⁹ Nevertheless Frydman, Rapaczynski, and Earle mention that in the summer of 1992, enterprises with over 30 percent share of foreign capital already had numerous tax allowances in Czechoslovakia (Frydman, Rapaczynski, and Earle 1993).
- ²⁰ Kulhánek claims that the foreign company Stabilo was awarded investment incentives and stole Koh-I-Noor employees, although the Czech company worked fine and exported its products, but did not receive incentives (Pohanka 2003).
- ²¹ There are different classifications of the balance of payment. I use the classification set by the Czech National Bank.
- ²² I depict longer data line because it is interesting in our view.

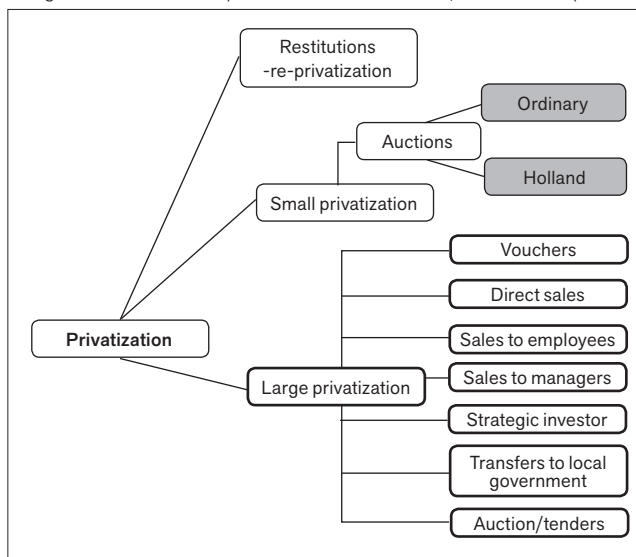
CHANGE OF PROPERTY RELATIONS AND PRIVATIZATION

It was obvious to us that no result of the privatization,
and this is the core of the problem, would ever be accepted by public.

—Dušan Tříška (2002)

At the beginning of 1990, the ownership structure in the Czechoslovak economy was monolithic—with nearly 100 percent state ownership. It is clear that such ownership structure makes it easier for state planners, but it is totally unsuitable for the market mechanism functioning. Economists therefore tried to find a way to privatize this property. Before 1994, they succeeded (at least formally) in transferring 80 percent of the property to private hands (Švejnar 1997). I now turn to the discussion of the methods of this denationalization. I remove discuss restitutions, small privatization, mass privatization, until 1994, and continuation of privatization after 1995. In the final subchapter I evaluate the whole privatization process.

Figure 7.1: Privatization process in Czechoslovakia/the Czech Republic



7.1 Restitutions

Restitution (sometime reprivatization) is a process of returning property confiscated illegally by the state to its original owner. After the regime change, there was an intensive discussion about whether and to what extent should restitutions be carried out. Strong interest groups opposed it, including proponents of the previous regime, managers of involved enterprises, and some economists. The economists were afraid that restitutions would slow down and interfere with the privatization process (for example, Tríska 2002) and they were also concerned about social acceptability of property returning.¹ Klaus was against and argued that in most cases the property is not being returned by those who stole it, but by people who also suffered under the communist rule (Klaus 1995a). He also believed that those who demand the returning of stolen property contribute to meaningless disputes that may become “a barrier separating us from each other.”

The restitution process faced numerous problems. It was necessary to set the date from which restitutions could be claimed, decide whether the compensation would be financial or material, how to evaluate the property, decide which subjects would be entitled and how to define former owners (who often fled the country), all of this under political pressure that was against the whole restitutional process. In Czechoslovakia, it was decided that the restitution would cover the property confiscated after the communist coup d'état in 1948, and that it would apply only to Czechoslovak citizens and, in special cases, churches. Restitutions thus did not include corporations, associations, societies, and foreigners (Kotrba 1997). Earle and colleagues add that 82.3 percent of assets in productive sectors were nationalized already in 1948 (Earle et al. 1994).

The entire restitution process was launched at the end of 1990 and lasted throughout the decade, with repercussions in the new millennium (FNM 2004). Data about the total value of returned property differ—for example, Holman quotes 25 billion CZK, Dyba and Švejnar quote 3–4 billion dollars (approx. 100–140 billion CZK), and Kotrba quotes 75–125 billion CZK (see Dyba and Švejnar 1999; Holman 2000; Kotrba 1999). Others estimate the value of returned property at 70–130 billion CZK in accounting value (Report on the State of Czech Society 1999).²

According to Fawn, restitutions involved 30 percent of state-owned property and 30 percent of citizens (he quotes an unpublished document of

the US Embassy; Fawn 2000). Myant claims that approximately 15 percent of people profited from restitutions (Myant 2003). Restitutions had quite a strong impact in some branches—for example in retail shops in small towns (Fawn 2000; Kotrba 1997).

Property was generally returned in a physical form. If it was impossible then financial restitutions were provided. In some cases the claimants could get a share of their company but the main source of financing restitutions was the so-called Restitution Investment Fund (RIF). It collected a portion of resources acquired from privatization—3 percent of shares of enterprises incorporated in the voucher privatization were paid to the fund. Shares of this fund were paid to restitution claimants, and they also received 30,000 CSK in cash. According to the law, restitutions had advantages over privatization. It meant that it was necessary to count with restitution requirements in the privatization projects.

Initial concerns of slowing down of property transfers to private hands as a consequence of restitutions proved to be well-founded (Dobešová et al. 2003).³ Frydman, Rapaczynski, and Earle describe the restitution process as controversial, expensive, and time-consuming (Frydman et al. 1993). Some restitution cases dragged on throughout the entire decade. However, if the politicians wanted to create a credible law-abiding state, I believe they had to try to come to terms with the wrongdoings of the past. Czechoslovakia was the only country in the Eastern Bloc that carried out physical restitutions (Lavigne 1999). Ježek believes that restitutions proved in the end the best and most efficient method of privatizing (Ježek 2006).

7.2 Small privatization

Another major property transfer process was launched in January 1991—the so-called small privatization. It consisted of sales of small units, such as service shops, retail shops, and restaurants (manufacturing companies represented less than 2 percent).⁴ There was a strong pressure from the employees and management of small companies to get first call on the property by mid-1990. But highly negative reaction of public and media led to a rejection of this proposal. Instead, public auctions were used as the privatization method (Urban 2005). The employees did not have any advantage (in form of lower price or first call) when compared to other countries (Earle et al. 1994).

Public auctions were managed by local privatization commissions.⁵ Their task was to announce the list of privatized units at least thirty days before the auction, together with the basic data. In case of weak interest from the buyers, the so-called Dutch auctions were used,⁶ in which the put-up price could have been lowered (down to 50% in the first round and up to 20 percent of the initial price).⁷ In the first round, the property was sold to home entrepreneurs, and if they were not interested, foreign capital was allowed to come into play (Frydman et al. 1993).⁸ The owner of the units—usually a large enterprise—had a chance to file a complaint against putting the unit up for privatization. The entire process began on January 26, 1991.⁹ The last auctions took place at the end of 1993, while most auctions were carried out in 1991 and 1992. Small privatization development is summarized in Table 7.1.

Table 7.1: Small privatization in Czechoslovakia

	1991	1992	1993
Enterprises approved for privatization	24,523	32,289	33,359
Privatized enterprises	14,155	22,487	24,359
in auctions	12,492	20,182	21,093
rental contract	1,521	2,090	3,036
restitutions	142	472	582

Source: Holub (1996).

In the Czech Republic, 22,212 units were sold for 30,052 million crowns during the small privatization process. The put-up price was 21,028 million and so the sale prices were on average almost 50 percent higher (Kotrba 1997).¹⁰ Revenues went to the account of the National Property Fund (see BOX 47).¹¹ Roughly 50 percent of the property was privatized by their respective employees and managers even if their only advantage was in knowing the property (Urban 2005).

BOX 47 National Property Fund

The National Property Fund (FNM) was an important transformation institution. The fund was established in 1991 and its task was to carry out privatization decisions of the government. Circumstances of its origin are ambiguous. The fund was incorporated in Vlasák's team (i.e., the Czech government's) proposal in the spring of 1990 (Sojka 2000). However, the reformers did not like the notion. Ježek notes that the plan was to create some kind of recovery fund with "the character of a new planning commission" (Ježek cited in Husák 1997).

Klaus regretted that its creation was not prevented and Tříška perceived the establishing of the FNM as a leftist attempt at stopping the privatization (except for perhaps the small and employee forms) and to involve a national "holding" in the process (Klaus 2001; Tříška 2002). The fund was created, but it was only assigned a passive role and the property just "flowed through it." Tříška still considers the FNM to be the gravest institutional error in the entire privatization process and possibly in the entire transformation (Tříška 2002).

During the mass privatization, the FNM did not have any decision-making authority (it belonged to the Ministry for Administration of National Property and Its Privatization). The FNM only carried out the decisions and received revenues. Furthermore, from mid-1994 the FNM was chaired by the advocates of quick reforms Tomáš Ježek and Roman Češka. Ježek said in an interview in 1992 that the Fund's goal was to make its ownership of enterprises as short as possible (Klvačová 1992a). The FNM had no ambition to administrate and restructure the property. This approach survived after the mass privatization, when the FNM portfolio still contained numerous enterprises. Its non-intervening policy was widely criticized; the *Ekonom* magazine noted that enterprises managed by the FNM were practically paralyzed and unable to make decisions regarding any larger investment or restructuring (Ekonom 1994b). The authors of the article claim that the fund did not prevent managerial extravagance in its enterprises; for example prohibited dividing the former state-owned property, which bordered on theft.¹² Nevertheless, Havel wrote that the FNM did not have any real authority to act against large enterprises—the authority remained with the government and its key ministers (Havel 2001). In 2004, he noted that the directors of large enterprises were often more powerful than their "superior" officials in the FNM and in the ministries (Havel 2004). Schwartz pointed out that it was difficult to recruit experts to represent the FNM in the enterprises (Schwartz 1997). Havel adds that although these representatives were named by the state, they were responsible only to the enterprise (Havel 2004). They were not allowed to provide the state with confidential information or to consult their decisions with state institutions.

After the mass privatization, the FNM carried out standard privatization—tenders, public auctions, and restitutions (Hrubý 1999). Around 1994–95, the FNM was burdened with these tasks and was lagging behind, because it worked on too many duties. It led to pressure on speed, resulting in poor quality and growing numbers of bad payers.¹³ The regime was later tightened and bad payers were eliminated (Hrubý 1999).

The FNM gradually sold its shares in enterprises. Its revenues from privatization were not transferred to the budget but were used to finance mandatory obligations of the state, such as removing environmental damage, clearing privatized enterprises from debts, capital strengthening of enterprises, transformation and stabilization of the banking sector, or boosting social retirement and health insurance funds (Hindls, Holman, and Hronová 2003).

The FNM terminated its activity in late 2005.

.....

The process of small privatization was accompanied by several problematic aspects. Seventy-five percent of objects were auctioned without the rights to the property, so the real subject of the auction was just a contract of lease, initially for two years and later for five years (Frydman et al. 1993). Furthermore, enterprises beneficial to the public were burdened with the right of user for ten years. The most problematic aspect of the entire privatization was probably its financing. Since most households had no substantial savings in the initial phase of the transformation,¹⁴ the entire process was financed by loans from the Fund of National Property and from banks (see Ježek cited in Husák 1997). There partly lie the roots of the subsequent problems of the banking sector. Plus, the new owners acquired “clean” property without any liabilities, so the large enterprise was being sliced, until it owned only liabilities (Ježek 2006). Another interesting aspect is that in Czechoslovakia, in comparison to other countries, were only minimal conditions on the new owners for assortment—only groceries had to sell foodstuff for one year (Earle et al. 1994).

The process of small privatization in general is assessed positively (e.g., Fawn 2000; Holman 2000), and as quick and problem-free (e.g., Švarcová 2002). Klvačová and Buchtíková wrote about its demonstrative effect, which provided a practical and tangible example of state ownership successfully replaced by private ownership (Klvačová and Buchtíková 1992). Small privatization also freed the economic environment and provided opportunity for establishing small- and mid-size businesses. Sacks maintains that late in 1991, small private companies carried out 41.3 percent of all retail sales (Sacks 1993). However, the fact that the privatization was mostly financed with loans determined the subsequent fate of sold enterprises. They often ran into troubles getting new bank loans and resorted to supplier credits, often left unpaid and resulting in the so-called secondary insolvency.

7.3 Mass privatization, 1991–1994

The forty years of state ownership proved that the state is a bad owner, which was the main reason why the property was transferred into private hands. Moreover, centrally planned directive enterprises' management in the new system was hardly imaginable (Klaus 1999). Economists were afraid that the government would not be able to withstand the pressure of lobby groups for subsidies. Therefore the cabinet opted for quick privatization, without the state trying to restructure the property—the task was left to new owners. As the amount of state property was huge, the government economists voted for a mass form of privatization—it was carried out between 1991 and 1994 in two waves. Privatization was supposed to increase effectiveness of the economy as a whole (e.g., Tríska 2002). It was also supposed to break monopoly structures on the market, and create a market environment and break the power of the communist state, limit the time of the so-called pre-privatization agony and overcome the resistance of interest groups in enterprises and in the state bureaucracy (Holman 2000; Ježek cited in Husák 1997; Lavigne 1999).¹⁵ Fiscal tasks—gaining revenues for the state budget—were not the primary goal of the mass privatization in Czechoslovakia.¹⁶

In this chapter I first of all analyze the discussion about the pace of the privatization. Next I proceed with the main parts of the privatization process – with privatization projects and methods. The most important method in the mass privatization was voucher privatization and due to it I devote the next subchapter to this method. And in the end I sum up the general discussion about the mass privatization.

Dispute about the pace of privatization

One of the major disputes in the entire transformation was about the pace of privatization.¹⁷ What were the reasons for quick privatization? Klaus writes that the effort to carry out mass privatization as quickly as possible was motivated by fears of “spontaneous” privatization into the hands of existing managements, which happened for example in Hungary (Klaus 2004). He did not agree with transfer of ownership to existing management that was often deeply (inter)connected with the communist party, mostly in the form of direct membership. These worries were not exaggerated. The government

of ČSFR warned already in one of its materials in 1990 (Vláda ČSFR 1990) that management and even employees of some of the state companies deemed the property as “their” and behaved accordingly.

Similarly, Holman claims that quick privatization was motivated by fear of pre-privatization agony—that is the situation in which managers just wait or, even worse, tunnel the enterprises (generally sell assets cheaply to their own companies), which was happening in all transforming economies, because the state failed as the owner (Holman 2000). Mlčoch believes that primary reasons for quick privatization were political—to meet the promise given to the public that the transformation process and catching up with advanced economies would be fast (Mlčoch 2000). Quick privatization was supposed to contribute to the “thick line” behind the past.

Opponents often claim that full-fledged market institutions should have been created before privatization was launched (see e.g., Mlčoch, 1997). Janáček contradicts this criticism by asking whether it is possible, other than in the virtual world of theoretical considerations, to build a market economy without its principal constituting element—private ownership (Janáček 2000). Quick privatization involved the potential danger of choosing bad owners who might turn out even worse than the state (Holman 2000). This is why some economists proposed slow standard methods.¹⁸ However, advocates of quick privatization argued that such an approach would take decades (Holman 2000).¹⁹ Another opponent of quick privatization points out that quick privatization—without finding the optimum owner—led to post-privatization agony, that is situation with no real owner (Mládek 2002). This viewpoint is in accordance with Mlčoch’s theory of short and long path. The short path meant the quickest privatization, but the ownership change was purely formal (Mlčoch 2000). This approach proved to be counterproductive owing to weak institutions, and led to the so-called recombined ownership, where the state kept its influence in companies through banks. The long path means introducing a strategy of managing denationalized enterprises, with managers employed on contracts that include motivation points. The state would not intervene in decision making on the microlevel, and the private sector would emerge gradually. Skála expresses his doubts about such an approach and asks whether the state would be able to supervise so many managers in so many denationalized enterprises (Skála 2003). Was there a danger of “private entrepreneurship at the state’s expense”? Would the long path be able to privatize effectively or would the entire process just be slowed down?²⁰

I cannot help but to express my feeling that the criticism of the pace of privatization was just another attempt at slowing down the entire process. What would happen to enterprises in the meantime? Would it not lead to prolonging of the preprivatization agony, condemned so vehemently by the opponents of the quick path (Mlčoch 1997)? My opinion is that it was either possible to strive for quick privatization, with shorter pre-privatization agony and at the expense of a worse selection of owners, or to try to find better owners, while in the meantime the assets would probably be withdrawn from the enterprises—a process referred to as “tunneling”. Sommer and Tůma sum up the situation by saying that the state was forced to choose between the pace of privatization and the quality of new owners in privatized companies (Sommer and Tůma 1999). Loužek (2002) quotes Table 7.2.

Table 7.2: Analyses of the pace of privatization

	Quick privatization	Slow privatization
Advantages	Quick denationalization, cutting off enterprises from the state budget. Enterprises are thrown into the “cold water,” learning to understand market incentives	Possibility to choose a suitable strategic owner judiciously
Disadvantages	Complicated settling of property rights after privatization	Pre-privatization agony. Strengthening positions of nomenclature managers. “Wild” privatization threat

I believe there was no ideal path that covered both dangers. It is naive to believe that the state bureaucrats would be able to control enterprises in the period before privatization. They did not succeed in doing so even in the relatively short time of the Czech privatization and selecting a “good” investor would take much longer. Besides, the ability of bureaucrats to choose good investors is arguable, to say the least. Generally when I focus on the real and deep causes of these disputes I have to state that in the very core stands again the attitude toward the government; to be specific, the trust or mistrust of the individual authors.

Aside from these theoretical disputes, we might also ask how quick Czech(oslovak) privatization really was. Lavigne, for example, claims that even the quickest privatization methods (i.e., in Czechoslovakia) took eighteen months, which he perceives to be a long time (Lavigne 1999). Similarly Havel writes that although the first privatization period was administratively—owing to nonstandard voucher privatization method—very short, from an

economical standpoint it was too long (Havel 2004). The state resigned from the active control of the enterprise sphere in its ownership in 1990, and the first voucher owners took control of their positions in the spring of 1993 (the second wave in 1994). Kotrba writes about sacrificing the privatization pace to stronger competition between proposals and looking for an optimum method of privatization (Kotrba 1997). Sacks maintains that in reality this was a compromise between shock privatization and slow negotiation model (Sacks 1993). Besides, privatization did not finish with the end of voucher privatization, it was continuing in following years. Consequently, some authors perceive the slow pace of privatization as one of the crucial problems of the entire transformation (e.g., Schwarz 1998). On the contrary, Fawn assesses the Czech privatization as the fastest and the most centralized of all postcommunist countries (Fawn 2000).

Ending the entire process is quite another issue, because finishing the subsequent privatization was very complex. It is clear, though, that the basic privatization measures were taken quite quickly compared to most other postsocialist countries.

Privatization project: Strategy

Czechoslovakian mass privatization had several specific features, primarily the fact that there was a competition among submitters of privatization projects. In ČSFR, anyone could submit a privatization project for any company listed in the privatization program. Holub claims that on average five privatization projects were submitted for one enterprise (Holub 1996).²¹ Managements of privatized enterprises were obliged to do so. Submitters were allowed to use various privatization methods, often combined.

In June 1991, the list of companies designated for the first wave of privatization was published. The company management was obliged to present its privatization project before November. Competing projects were submitted before next February.²² The project submitted by the management had to include a plan for the entire enterprise, but competing projects were allowed to propose privatization of its selected sections. Relevant ministries assessed the projects, but the final decision and selection of the winning privatization project was done by the Ministry for Administration of National Property and Its Privatization; or by the government in case of direct sales.^{23,24} After

approving the privatization project, the enterprise property was transferred to the FNM, which carried out the privatization proper, executed property rights of unsold property, and collected revenues.

Generally speaking, submitters of competing projects had a fair chance against the management (Kotrba 1997). In reality, however, it was rather unusual if a submitted project was prepared by people from outside the privatized enterprise. Proposals were often submitted by employees or the management of subsidiaries. The main advantage for this group of submitters was the fact that their projects did not have to include proposals for the entire enterprise—they could choose only the healthiest and most profitable parts. However, the management had better access to information and could manipulate economic results of enterprises (Kotrba 1997). Kotrba also discusses methods used by the management in privatization projects:

- a) buy the entire company;
- b) buy a share;
- c) “pick the raisins”—effort to get hold of the most profitable part of the enterprise directly and privatize the rest using other methods;
- d) clean the enterprise from ballast;
- e) act as a third-party agent;
- f) maximize other advantages without getting an own share in the enterprise;²⁵
- g) prolong privatization—and make use of the absence of the owner’s control surveillance. The management thus prolonged the period of preprivatization agony—an ideal time to distort the accounts and abuse the lawlessness for own enriching, to prevent others from acquiring information, and so on.²⁶

7.3.1 Privatization methods

The voucher method was not the sole and, according to some economists, even the principal method of privatization.²⁷ All methods were equal by law.²⁸ Other property transfer methods included:

- Public auctions—the only selection criterion was the price. Usually used for very small units or shares.
- Public competitions—tender, multicriteria method—did not take only price into account, applicants had to meet other criteria as well. The

method was used mainly for small enterprises. It allowed for a more sensitive approach, but on the other hand, provided room for manipulations and corruption (Klvačová 1992b). It was also more demanding for administration compared to public auctions.

- Direct sales to a preselected applicant, without public competition. The method transferred the selection process from anonymous market forces to the state bureaucracy. Klvačová maintains that the method increased the importance of personal contacts, liaisons, and corruption (Klvačová 1992b).²⁹ In reaction, a stricter regime was introduced and direct sales had to be approved by the government.
- Transformation to joint-stock company and sale of shares. Shares could be used in voucher privatization and/or sold through a bank or stock exchange.
- Free transfer of property to municipalities, villages, social security funds, original owners—this method was used for apartment buildings, kindergartens, and so on.
- Temporarily leaving the property in the ownership of the National Property Fund.
- Using employee shares—maximum 10 percent of privatized property.

For most enterprises, the first step was to convert the enterprise to a joint-stock company, as defined by the Law on State Enterprises 4/1990.³⁰ Most enterprises were subsequently privatized using combined methods—for example some shares were turned into vouchers and the rest was sold in a standard way or it remained in state ownership. Jitex Písek is a good example: 69 percent of the property went to vouchers, 10 percent for direct sale, 5 percent to employee vouchers and the rest went to Restitution and Endowment Fund, to the Health Insurance Fund, and was transferred to local authorities free of charge. The amount of shares provided for individual methods was defined in the privatization project.

There were disputes about the percentage of stock for the voucher privatization (for example, Tríska 2002; see also Ježek cited in Husák 1997). Ježek criticizes the Ministry of Finance that wanted to enlarge the amount of property for the voucher privatization (Ježek 2006). He says that the authors of the voucher privatization wanted at minimum a few high quality companies to be part of it to attract the interest of inhabitants.

Direct sales also played an important role in several large companies—for example Škoda Auto was sold to Volkswagen. Auctions and public competitions were much less important, but some key companies were sold through a public competition; for example, Škoda Plzeň was sold to Nero,³¹ and Poldi Kladno to Bohemia Art. Employee shares were approved as a privatization method in 490 enterprises, but employees were interested in only 188 of them (Holman 2000). Within the framework of the mass privatization, 7,553 units valued at 30 billion CZK, plus the shares of several joint-stock companies in the nominal value of 47.9 billion CZK were transferred to municipalities for free (Kotrba 1997).

Even in the so-called standard privatization approaches, the government preference for Czech ownership was clearly evident—this approach was later referred to as the so-called Czech way even if the term does not have a clear and unambiguous definition (see BOX 48).

BOX 48 The Czech way

The term Czech way is a fairly problematic term due to its ambiguous definition.³² Orenstein understands it as a sale of enterprises to Czech owners, and so does Klaus (1999; see also Orenstein 2001). Čermák defines it as a selection of privatization subjects based on maximum offered price (Čermák 2000).³³ Other authors do not attempt to define the term at all (for example, Sommer and Tůma 1999). Should the voucher privatization be considered as a part of the Czech way? Sales to domestic applicants perceived as the elite Czech entrepreneurs at the time are usually quoted as the principal examples of the Czech way of privatization. This is how Škoda Plzeň was sold to Mr. Soudek,³⁴ Poldi Kladno to Mr. Stehlík and Chemapol Group to Mr. Junek. All these privatization attempts eventually ended in a disaster (for specifics, see Myant 2003).

The effort to sell enterprises to Czech hands had numerous reasons, including political moods, opposing “sale of family silver,” and “German colonization”. Klaus writes:

It has recently become fashionable to criticize the “Czech way” of privatization. I cannot imagine what would have happened if we, in the summer and fall of 1990, in the scenario of economic reform, had recommended anything but the “Czech way,” in other words an attempt to create Czech capital through privatization and not to sell

everything we had to foreign capital. Those who claim otherwise probably did not live in this country in 1990–92. (Klaus 2001)

Similarly, in 2004 he wrote the following about the privatization:

Another initial notion [in addition to mass-nature and pace] was that the key role should be played by domestic economic subjects and that the economy must not be “sold out” abroad, to ensure the necessary sense of “participation.” This is why it was necessary to artificially cheapen at least a part of the privatized assets and to sell them “solely” to domestic hands. (Klaus, 2004)

Sommer and Tůma maintain that the “Czech way” privatization attempt was partly caused by lobbying and partly by naïveté (Sommer and Tůma 1999). The authors also claim that such approaches will be paid for dearly—often by bankruptcy. They say that the Czech way was the effort to insert a mediator between the seller (the state) and a capital-strong buyer (in case of big enterprises often a foreign subject). These mediators (quasi owners) cannot compete in a highly open economy without their own capital and, sooner or later, they will sell their assets. The authors believe that such an approach would make sense if the subsequent sale were quick, the mediators received their commission and invested at least a part of it back into the economy in the form of debt-free capital. This would generate genuine Czech capital, but at the expense of the state, that is taxpayers. However, they claim it never happened, neither with the voucher privatization, nor with direct sales.

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Foreign capital had to face several—although relatively moderate—obstacles. For example, foreigners were allowed to participate in small privatization only if domestic subjects were not interested. Foreign buyers had to present proposals based on audit, while Czech applicants were allowed to use accounting value.³⁵ Nevertheless, selling to Czech hands was often a necessity if the government wanted to keep the sold enterprises together—potential foreign buyers were usually interested only in the most lucrative parts—for example Siemens in Škoda Plzeň (Hudec 1999; Myant 2003).

7.3.2 Voucher privatization

Voucher privatization was a dominant method of privatization—almost 50 percent of all joint-stock companies were offered for vouchers. Dušan Tříška, Tomáš Ježek, and Václav Klaus are usually named as authors of the Czechoslovak form of voucher privatization.³⁶

The purpose of voucher privatization was to quickly transfer property rights, so that the restructuring of enterprises would be done by new (final) owners (for example, Holman 2000). This approach is considered to be ill-conceived by some economists (Sojka 2001). Other authors claim that this is an evasive formulation used since only the mid-1990s when it turned out that the initial owners were not optimal (Fuchs 2002). The targets of voucher privatization (as defined by its originators) include:

- establishing a positive relationship of citizens to the market economy and gaining experience in living with it;
- quick transfer of property and limiting preprivatization agony;
- just division of property among citizens;
- breaking the resistance of interest groups in the enterprise sphere and in the state bureaucracy; otherwise there was a danger of delayed privatization and prolonged pre-privatization agony;
- preventing spontaneous privatization.³⁷

Mechanism

The process of voucher privatization itself had several stages. In the first stage, investment privatization funds (IPF) were registered. This registration was not automatic—the Ministry for Administration of National Property and Its Privatization could deny it.³⁸ Unfortunately the IPF law created probably the main problem in the whole privatization process because it allowed the founders (administrators) of the funds to get a majority share in their fund and thus behave as owners of the fund instead of administrators (Ježek 2006).

The second stage involved registration of participants—all Czechoslovak (Czech in the second wave) citizens over eighteen years of age with permanent residence in the country were allowed to participate. For a fee of 1,035 crowns (approximately a week's pay) each citizen was entitled to

obtain one voucher book in the nominal value of 1,000 points, divided into ten parts. By buying the voucher book, a citizen became a so-called holder of investment vouchers (*držitel investičního kupónu*; DIK). In the next stage, investors (DIKs and funds) were provided with lists of offered enterprises with basic data (name, address, business activity, identification number, revenues, profit, number of employees, indebtedness in the last three years, basic equity, number of shares, number of shares allotted to vouchers, existence of the golden share³⁹).

The fourth stage consisted in the so-called zero round, in which the citizens could invest their voucher book (or its part) in investment privatization funds. If they did not use this opportunity, they had to invest in the following rounds on their own.

The fifth stage involved individual rounds of voucher privatization, in several steps:

- I. Amount of shares offered for sale in the round was announced together with share prices (i.e., the ration between shares and points).⁴⁰
- II. DIK's and investment privatization funds ordered shares.⁴¹ These orders were collected in points and sent to central processing. Funds were not allowed to own more than 20 percent of the enterprise.⁴²
- III. Orders were processed in the Voucher Privatization Center. There were several possible outcomes, which were reacted to in the following ways:
 - a) demand was in equilibrium with supply or it was lower than supply. Under such circumstances, all orders were settled in the original volume;
 - b) demand was higher than supply, but by less than 25 percent. In this case the demand of investment funds was cut to balance the supply with the demand;⁴³
 - c) demand was higher than supply and it was impossible to cut. Under such circumstances, investments were canceled and all investors got their points back.⁴⁴
- IV. For companies that were not fully sold, prices were set for the next round. The prices were based on the results of the previous round by the price commission of the Voucher Privatization Center using an unpublished algorithm. In case of excess of demand over supply, the price of shares went up. If demand was lower than supply then the price declined. Another round could start then.

A privatization wave was ended by the Ministry of Finance in a situation of “reasonable” convergence. Unused vouchers expired. Once the wave ended, shares were handed over, and investment privatization funds issued their shares.

Course of events

Voucher privatization was carried out in two waves; the first wave was federal. Basic data about the voucher privatization are presented in Table 7.3.

Table 7.3: Basic data about voucher privatization

	First wave	Second wave
Registration of DIKs	11/1991–2/1992	10–12/1993
Zero round	2–4/1992	12/1993–3/1994
Rounds	5–12/1992	4/1994–12/1994
number of rounds	5	6
Official end	1/31/1993	12/31/1994
Number of investors	8.540 million (CR–5.950 mil)	6.160 mil
Number of funds	429	349
% of points in funds	71.9%	63.5%
Number of offered enterprises	1,491 (988 in CR)	861
property of offered enterprises	299.39 billion of CZK (212.49 in CR)	155 billion of CZK
Property per one investor	35,057 CZK	25,162 CZK

Source: Kořená and Kořený (1995).

The first wave of voucher privatization began in November 1991 with the registration of DIKs. Necessary institutional measures were taken earlier—the Voucher Privatization Center was founded in June 1991. The privatization was popular and 5.95 million out of 7.4 million entitled Czech citizens participated. Approximately 4 million people in the entire federation were expected to participate and with the maximum of 8 million participants the reality thus exceeded the expectations and voucher books had to be reissued (Kořená and Kořený 2001; Voucher Privatization Center 1995; see also BOX 49). Investment privatization funds played an important role in arousing the interest (see the following box).

BOX 49 Viktor Kožený and Harvard Group

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The most controversial of the investment privatization funds were the Harvard Funds that were established by Viktor Kožený (1963–). He is probably the most problematic person of the whole privatization process. His parents emigrated to Germany in 1979. He moved to the United States in 1982 and earned a bachelor's degree at Harvard University. He returned to Czechoslovakia in 1990 and worked as a consultant for several ministers. He founded the Harvard Funds in 1991. There was no connection between the funds and the University. The funds lured DIKs onto the so-called tenfold security— a promise of payment of 10,000 CSK per a voucher book. His campaign was highly successful.⁴⁵ The Harvard Funds became one of ten biggest funds in the privatization process.

Kožený moved to the Bahamas in 1994 and obtained Irish citizenship. The transactions of the funds became questionable in the mid-1990s and he allegedly took millions of dollars from them via offshore tax heavens. In the second half of the 1990s, he was involved in a privatization process of petrol industry in Azerbaijan. This transaction was not successful and additionally he was blamed by the US Justice Department for corruption in this case. He spent several months in jail and was released on bail. In 2012, the Bahamas court decided that he cannot be extradited to the United States. Meanwhile, the Czech courts sentenced him in 2010 to ten years in prison in absentia and return of 16 billion crowns. Kožený insists on his innocence and says that over one million of DIKs not only received tenfold of their investment but often even eighteenfold of their investment. And that his then business partners stole the rest of the property from the funds and he was not able to pay out the rest of the DIKs. The highest court rejected his appeal and approved the penalty in 2014.

.....
The process of DIK registration was terminated in February 1992. Then came the zero round that lasted until April and in which the DIKs could subscribe their voucher books to funds. Investment rounds lasted from May until December. Almost 1,500 joint-stock companies were included in the first wave of voucher privatization.⁴⁶ The first wave officially ended on January 31, 1993. Shares were handed over to investors and funds.⁴⁷

It turned out that most people entrusted their vouchers to funds (72 percent of all vouchers). Moreover, these points were quite concentrated. The ten most successful investment privatization funds received 56 percent of all points

assigned to funds. The strongest fund acquired 20 percent of shares in 102 companies. The five largest funds had enough points to control (over 50 percent) 272 companies and 30 percent of shares (usually enough to control the enterprise) in 622 companies. The biggest investment funds can be seen in Table 7.4.

Table 7.4: The biggest investment groups according to points in the first wave of voucher privatization

Ranking	Investment group	Points (million)	Share %	Key persons
1	Česká spořitelna	950	11.1	Miloslav Kohoutek, Jaroslav Klapal, Karel Kotrba
2	Investiční banka (Česko—PIAS)	724	8.5	Miroslav Tuček, Jiří Tesař, Libor Procházka
3	Harvard Capital & Consulting	639	7.5	Viktor Kožený, Juraj Široký, Boris Vostrý
4	Všeobecná úverová banka	501	5.8	Jozef Mudrik, Dušan Paulík
5	Komerční banka	466	5.4	Richard Salzmann, Karel Bednář
6	Česká pojišťovna	334	3.9	Vlastimil Uzel, Jaroslav Daňhel
7	Slovenské investície	188	2.2	Miroslav Nakládal
8	Slovenská sporiteľňa, VSŽ Košice	169	2.0	
9	Creditanstalt	166	1.9	
10	Investiční banka (Slovensko—PSIS)	145	1.7	Peter Vajda, Jozef Tkáč
11	PPF	118	1.4	Petr Kellner, Milan Vinkler, Štěpán Popovič
12	Živnostenská banka	118	1.4	Jiří Kunert
13	Slovenská poisťovňa	117	1.4	Blažej Krasnovský
14	Agrobanka	111	1.3	
	Subtotal	4,744	55.4	
	Other IPFs	1,367	16.0	
	IPFs together	6,112	71.4	
	DIKs	2,454	28.6	
	Together	8,566	100.0	

Source: Mejstřík (1997).

Only approximately 7.2 percent of shares remained unsold and about 1.2 percent of points was not used. Investment funds had only 0.33 percent of their points left, while individual investors had approx. 3.3 percent left. 498

DIKs did not succeed in subscribing a single point although they invested in all rounds. Most investment orders were issued within separate economies, but the Slovaks invested in the CR more than vice versa; Sacks maintains that while 10 percent of Slovaks used their vouchers to buy in the Czech Republic, only 1 percent of Czechs invested in Slovakia (Sacks 1993). The wave generated profit for the state in the amount of six billion CSK.⁴⁸

The second privatization wave—due to disintegration of the federation—took place only in the CR. It was, in some way, announced more or less inertially, because the original proposal counted with two waves. Tříška writes that this was a period of a certain privatization fatigue and it is dubious whether the second wave would have otherwise been announced at all (Tříška 2002).

Registrations of citizens began in September 1993 and lasted until December. Even more people participated than in the previous wave—6,169,000. The zero round took place from December 1993 until next March, while individual rounds were announced between April and December 1994. The second wave of privatization was officially terminated on December 31, 1994. Shares were assigned in February 1995 and privatization investment funds issued their shares until April.

Table 7.3 shows that funds received fewer points than in the first wave—63.5 percent.⁴⁹ It was caused by delays in the issuing of fund shares after the first wave and also by breaking some of their promises. Points were also divided more evenly—the ten largest funds acquired “only” 35 percent of all points ascribed to funds. Eight investment funds acquired over 100 million points and 158 funds less than 1 million.

Approximately 3.6 percent of the offered shares remained unsold and 0.6 percent of investment points were not used. Over 100,000 individual investors did not assert all their points and 277 DIKs got no shares although they invested in all rounds. More than 1,000 complaints were registered during this wave, a remarkable feat for 13.5 million applied vouchers (Voucher Privatization Center 1995). The second wave also brought profit to the state, in the amount of 4.4 billion CZK. The profit was used for infrastructure and environmental projects (Ježek 2006).

More people participated in the second wave than in the first. In the first wave, nominal value of the property per participant amounted to 35,000 CSK, while the same number in the second wave was approximately 25,000 CSK. In the first wave, people invested in funds more. Investment strategies in both

waves were similar—individual investors preferred cheap shares, while funds preferred the more expensive ones.

The average basic equity of enterprises in the first wave was 350 million CSK and in the second wave 440 million CZK. Other methods than the voucher were used more frequently in the second wave—one-quarter of enterprises was privatized predominantly using the other methods. In the second wave, thirty-two enterprises were privatized by transferring over 50 percent of their shares for free—public services such as sewage systems, heat plants, and so on.

Disputes about voucher privatization

Voucher privatization (VP) was certainly one of the most controversial moments in the entire transformation.⁵⁰ The VP was a complex process with numerous positives and negatives. I will first analyze the process proper and then I will discuss its long-term consequences. Advocates and opponents of the VP associate the method with numerous aspects that are often not clearly defined.

Some authors assert that the VP meant equal opportunities for all (Laštovička et al. 1997; Liška 1996; Tříška 2002). Hrubý and Rudlovčák write that the state gave the citizens a chance to gain at least a little piece of what was in fact a giant sale of state property (Hrubý and Rudlovčák 2002). Tříška notes that the purpose of the VP was to show that privatization was not just for the chosen—especially not for the local and foreign “nouveaux riches” (Tříška 2002). Nobody was excluded from the privatization due to lack of education or money (domestic capital early in the 1990s was always deemed “dirty”). However, equal opportunities are questioned by the existence of insiders with exclusive knowledge about enterprises (Dobešová et al. 2003; Lavigne 1999). Although Mlčoch does not consider the method to be just, he does not elaborate why (Mlčoch 2000).

The entire VP process is also considered to be transparent by its proponents. Klaus writes that, as far as cleanliness goes, VP is unrivalled (Klaus 1999). Tříška maintains that corruption in the VP is a contradiction in terms, noting that no one ever proved that prices in VP were rigged (Tříška 2002). Češka insists that the percentage of tunneled companies after the VP was much lower than in the state-owned companies, where unsupervised managers

took out the assets and brought enterprises to bankruptcy (Češka 2003). Still other Laštovička, Marcinčin, and Mejstřík point to lack of transparency in the process, but do not provide any argument for their claims (Laštovička et al. 1997). Orenstein quotes examples of (alleged) corruption related to the VP (Orenstein 2002).

The VP enabled privatization in the situation of insufficient national savings. As I have already mentioned, savings were low in comparison to the scope of property on offer. The VP enabled privatization without the burden of loans (Holman 2000). Ellerman claims that loan privatization would have been more suitable and that the government should have provided the money, but he is the only one who appears to think so (Ellerman 2001).

Tříška further discusses problems with the evaluation of enterprises (Tříška 2002). He notes that in case of standard privatization, foreign advisors had to be used, often resulting in a situation when privatization revenues were lower than the money paid to these counselors. The VP led to market evaluation of enterprises and the prices resulted from the clash between supply and demand.

Another positive result of the VP was the establishing of the stock exchange and capital markets. People thus gained experience with the functioning of the markets that constitute the core of market economies. Besides, the VP enabled collective investment through investment funds (Laštovička et al. 1997). Others also praise the numbers of shareholders and the establishing of the capital market (Dillon and Wykoff 2002). By contrast, Liška writes that the VP provided a deformed image of capital markets and investment funds (Liška 1996).

Still another positive factor was the involvement of people in the transformation process and the fact that they gained experience with the market economy (Liška 1996). Schwarz writes that the VP became an important tool in the active involvement of the people in the process of economic and political changes (Schwarz 2003). Tříška notes that even if people lost some money in the VP, it was still quite cheaply gained experience in the functioning of the market environment (Tříška 2002). The VP was perceived, especially abroad, as a powerful proof of real economic changes in Czechoslovakia (Schwarz 2003). However, others believe that people were not ready for the privatization process yet (Laštovička et al. 1997). The pace of the process is sometimes assessed critically. Some also warn that the method brought neither new capital nor new management to the enterprises (Liška 1996).

Besides the mentioned positives and negatives earlier, we should consider the long-term consequences of the process, namely the criticism of the subsequent property structure and execution of property rights. Several concurrent arguments are intertwined in this criticism.

One such argument claims that the VP resulted in scattered ownership. For example, Liška points out the nonexistence of real owners (Liška 1996). Loužek argues that there is nothing wrong with scattered ownership as such, since it is commonly used in market economies (Loužek 2002). Klaus notes, in this context, that the form of collective investment (supposed to be governed by standard rules) was forced upon us by foreign advisors (Klaus 2001a). The consequence was a legislative requirement for the funds to diversify their assets. According to one analysis, the VP did not in fact lead to scattered ownership at all (Laštovovička et al. 1997).

Another more frequent criticism says that the VP led to a bad ownership structure, namely to ownership pyramids and tangled webs (Holman 2000).⁵¹ In some cases, the top of the pyramid was occupied by a bank.⁵² Since these banks were semi-state-owned, the resulting ownership structure was referred to by some as recombined ownership (Mlčoch 2000). Numerous authors criticize this linkage between banks, funds, and enterprises (Dillon and Wykoff 2002; Lavigne 1999; Mlčoch 2000). Pavlínek maintains that six out of nine and eleven out of fourteen of the largest IPFs were established and owned by state banks and insurance companies (Pavlínek 2002). And, four out of five largest IPFs were established by the largest banks, controlled by the state through the FNM. As a result, the new owners did not act as real owners. Sommer and Tůma maintain that funds did not execute real property rights (only financial transactions, sometimes even against the interests of shareholders), and were content with a vague enterprise strategy (Sommer and Tůma 1999). On the contrary, Hrubý and Rudlovčák write that the VP proved the assumption that private owners try to control managements better than the state (Hrubý and Rudlovčák 2002). Češka also opposes the assertion that the economy was taken over by banks and their investment funds (Češka 2003). However, critical voices prevail, saying that the result of the VP was weak management of enterprises, limited or no restructuring, and keeping unprofitable companies alive (for example, Sommer and Tůma 1999). Some economists claim that the state-owned banks were under pressure to grant loans. Another reason was that the banks followed their own interests—if the enterprise survived, there was a chance that at least some invested money

would be returned. Furthermore, Šimíková quotes a study that claims that bank-owned enterprises restructured faster than enterprises with other ownership structures (Šimíková 2003). The conclusion is that the banks in an owner/creditor position could be better at monitoring the managerial results and at restructuring enterprises.

Its critics claim that the VP resulted in a situation where one could not find real owners, just first owners. When the ownership concentrated, the so-called “third wave” of privatization was bound to take place. Advocates of the Czech privatization strategy argue, however, that such development was obvious from the very beginning, but others say that the reformers did not come up with this thesis before mid the 1990s (Holman 2000; see also Fuchs 2002).

In addition from the ownership issues, another area of dispute was the effectiveness of the privatized enterprises.⁵³ This discussion was provoked by the Report on the Condition of the Czech Society, produced by the newly elected social democratic government (March, 1999). The report claimed that the voucher-privatized enterprises achieved “unprecedented” bad results (in profitability, productivity, and dependence bank loans), even in comparison with state-owned enterprises. The best results were achieved by enterprises with foreign participation, while enterprises privatized by standard methods (usually loans), were somewhere in the middle. Češka (1999) calls the report distorted; he attacks the methodology and peculiar selection of enterprises used for the analysis (Češka 1999). A more serious attempt at an analysis was made by Kočenda and Lízal in 2002. The authors maintain that all studies bring the same result, namely that the VP led to worse structure of enterprise management and that enterprises from the VP were much more likely to go bankrupt (Kočenda and Lízal 2002). Another study claims that the differences in productivity depending on the used method of privatization are very small (see Šimíková 2003). Enterprises that promised good profitability were sold to foreign investors, often cleaned by the government, such as the car manufacturer Škoda (Loužek 2002). Regularly attractive firms were taken over by Czech strategic investors on credit. The rest of companies that (with slight exaggeration) nobody was interested in went to VP. If it were not for the voucher privatization, average and substandard enterprises would remain in the hands of the state, asking for fat subsidies (Loužek 2002). Others note that the companies in the VP represented 31.6 percent share in nonprofit companies and only 13.4 percent share in loss-making companies (Laštovička

et al. 1997). Nevertheless, the starting conditions were in my view crucial for the following development of the companies. The goal of mass privatization was not to improve productivity of individual firms, but of the economy as a whole, and in the long-term, not immediately (Hrubý and Rudlovčák 2002). Similarly Tříška writes that privatization is not a performance-increasing tool for individual enterprises, but rather for the economy in its entirety (Tříška 2002). Bennett, Estrin, and Urga in their international comparison conclude that countries that applied voucher privatization grew significantly more than countries that used other privatization methods (Bennett, Estrin, and Urga 2007).

Dillon and Wykoff condemn the entire VP as a mistaken notion because it led to incorrect stimuli for the enterprises and to noneffective allocation of resources (Dillon and Wykoff 2002). Orenstein writes that the VP was an expensive mistake (Orenstein 2001). Skála is a little more cautious, saying that the VP was not a bad method, but that the legal side of the affairs was misjudged and the dependence upon customs and behavior patterns of the previous era was underrated (Skála 2003). Similarly, Bokros believes that the voucher privatization was well-conceived, but on the wrong assumption that private ownership alone will cause positive effects (Bokros 2001). According to Fuchs, the role of the pace of the privatization process was overestimated, while the creation of institutions, regulation, and surveillance were underestimated (Fuchs 2002). Similarly Dlouhý claims that the voucher privatization proper was not the issue—the method was correct (Dlouhý 2003). The problem was in what did not follow—regulation, legislation, and competent business courts.

Conversely, Klaus says:

Voucher privatization fulfilled its task, with smaller expenses for the society than the alternate approach, with the state alone choosing optimum owners for hundreds of enterprises. Such a procedure would mean leaving most of the economy in pre-privatization agony for a long time, exposing formally state-owned but uncontrollable enterprises to widespread stealing from their temporary managements through spontaneous privatization, losing public support for mass privatization and involving the state bureaucracy in extremely complex, decades-lasting and corruption enticing negotiations with potential investors. (Klaus 2001a)

Most opponents of the VP did not understand the scope of this process correctly and they attributed it much higher ambitions than it could possibly have (Schwarz 2003). In Schwarz's opinion, privatization ended with the transfer of shares and the registration of new shareholders by the Prague Securities Center. Under given circumstances, it was carried out quickly, as planned and without widespread corruption. If standard methods were more widely used, corruption would be more prevalent ("the period after the end of the VP confirms that this hypothesis is correct"). Tříska maintains that in political negotiations (1990–91) no relevant political force ever contested the notion that the VP should be implemented (Tříska 2002). He remarks that the VP "was not the work of a narrow group of conspirators around Klaus and his advisors." One of the VP advocates, defends the method practically against any criticism (Loužek 2002).

I now would like to make a few comments on several aspects of the discussed disputes. First, the VP was a complex process. I think it is impossible to pinpoint only its negative aspects. Opponents usually do not mention any positives at all, providing only destructive criticism. It is certainly true, for example, that the method did not bring any new capital. But which method would have? We find out that the only choice left would have been selling foreign investors—a difficult method to apply in mass measure.

The existence of insiders in the VP is another frequently discussed point. This criticism appears entirely out of context to me. In what method would insiders not play any role? There will always be subjects with better knowledge of enterprises; this situation is inevitable. Employees will always have an advantage in privatization. The influence of insiders in the VP was relatively small, because the other participants' behavior played its role as well, while the role of employees was just 1,000 points per a person.

The issue of purity of the entire process appears in the same light to me. There are a few scandals related directly to the VP—essentially the Jaroslav Lizner affair.⁵⁴ Plus, it was never proved to him that he had any chance to manipulate the prices of points. The issue of alternatives is here again. Does anyone really think that if "standard methods" were massively used, there would be less corruption?⁵⁵ Unfortunately, one and by far the worst mistake was incorporated into the legal environment of the privatization funds (Pithart 2005). This is in my view a single fault that enormously damaged the overall view of the VP. The law allowed the administrators of the fund to abuse their position. It led to a situation when property of some of the funds

(e.g., CS Funds) was taken out via many different methods (e.g., unfavorable prices of shares). Ježek says that one-third of DIKs that had their vouchers in IPFs were robbed (Ježek 2006). He estimates that roughly 50 billion CZK out of 140 billion in the funds were stolen, without mentioning a method of this estimation. There is no other estimation and we do not have to agree with it. Regardless of this, the core problem is obvious and Ježek is without doubt correct. The conditions of behaving of the funds were tightened during the time and the problem was solved by the 1998 amendment, which made the IPFs transform into open-ended mutual funds. Some of the funds escaped this tightening by transformation into holdings that kept their previous unfair advantage. Ježek says that 40 out of the 50 stolen billions disappeared after these transformations. He generally says that the banks' funds behaved in a correct way and that their shareholders were not robbed. Even though he criticizes the setting of the initial law he does not say that it was an intention of the government or the lawmakers. He says that the bad law was a consequence of a three-government situation and time pressure.

Otherwise, it appears entirely irrelevant to me whether the people were ready for privatization. When were they? Could we say that they are today? Let us not forget the wide support the voucher method enjoyed and how massively people participated, including the fact that few of them lost anything in the transaction—that is gained less money than they had invested.⁵⁶

The initial ownership structure after the VP appears to have been really problematic. Fears of dispersed ownership led to establishing investment privatization funds. But due to complementary fears of their massive influence and the effort to protect small investors, the clause limiting their share in individual companies to 20 percent was adopted.⁵⁷ The ensuing question is: How were the owners supposed to speed up restructuring of companies if it was so difficult to acquire decisive majorities? The critics were also right that it took several years for the ownership structure to settle and for the enterprises to find majority owners. It is also certainly true that in the meantime property rights were not enforced in many enterprises. It seems that the privatization agony (pre and post) was nearly impossible to prevent. But how about the issue of linkage between banks and funds? Was the influence of the banks really as strong as some authors assert? Desai and Plocková (1997) quote the following interesting tables.

Table 7.5: Cumulative ownership on the Czechoslovak/Czech voucher market (in %)

Owner	Points total		Points held by funds		Shares total	Share held by funds*
	First wave	Second wave	First wave	Second wave	First wave	First wave
Individual	29	36.5	-	-	37	-
Largest fund	11.1	5.2	15.6	8.2	7.7	12.2
5 largest funds	38	21.1	69	33.4	27	42
14 largest funds	55.4	36.7	77.6	60.1	43	67.5
All funds	71.4	63.5	100	100	63	100
Funds owned by banks**	39.8	11.8	55.7	19.6	29.9	47.5
Total	100	100	-	-	100	-

* data on shares held by funds after the second wave were not made public

** funds controlled by large (formerly state-owned) financial institutions: 9 funds in the first wave, 5 funds in the second wave.

Source: Desai and Plocková (1997).

Table 7.6: Ownership of funds owned by five largest financial institutions in mid-1995

Mother company	First wave		Second wave		Both waves	
	Acquired points total (million)	Share in points held by funds (%)	Acquired points total (million)	Share in points held by funds (%)	Acquired points total (million)	Share in points held by funds (%)
ČS	950	15.6	124	3.2	1,074	10.7
IPB	724	11.9	98	2.5	822	8.2
KB	466	7.7	124	3.2	590	5.9
ČP	334	5.5	187	4.8	521	5.2
ČSOB	49	0.8	198	5.1	247	2.5
Total	2,523	41.5	731	18.8	3,254	32.4
All funds	6,112	100	3,920	100	10,032	100

Source: Desai and Plocková (1997).

It is true that six out of nine biggest funds were owned by banks and insurance companies, but Tables 7.5 and 7.6 show that the considerations about the strong influence of banks on the enterprise sector are probably exaggerated.⁵⁸ Although some authors often speculate about factual management of enterprises by the state via banks and the funds they control (recombined ownership), there is not much evidence of such activity (Havel 2004). I agree with this assessment; I did not find any proof of explicit influence of the state on the banks functioning in any source,⁵⁹ although it is obvious that specific evidence is hard to find.

The last point of dispute is the economic results of enterprises. This issue will probably remain unsolved forever. I believe that fundamental differences in the initial approach really existed—in methods that were used for enterprises with various prospects. Under such differing initial conditions, it is practically impossible to compare the results of individual privatization methods.⁶⁰ If mostly weak companies were privatized by VP then we should not be surprised by consequent weak economic results of these companies.

Alternatives to voucher privatization

Up till now, I have concentrated only on a discussion concerning voucher privatization. Now, I want to extend it to the discussion about alternative privatization approaches. It is easy to criticize the concept or results of the privatization but we should consider the alternatives to see the whole process in a more realistic way. The critics who are not purely destructive propose alternative privatization approaches.⁶¹ It is often argued that enterprises should have been sold using traditional methods—direct sales to domestic and foreign capital after restructuring. Another option was to give a free pass to managers—the so-called spontaneous privatization, or to transfer the property to employees. We should notice that the main factor of the discussion is again the role (trust/mistrust) of the government and markets.

The first option is sale to domestic subjects and it was preferred by numerous critics. They are motivated by the effort to avoid voucher privatization, while preserving domestic ownership of enterprises. This option was implemented in some aspects of the aforementioned Czech way—mammoth enterprises were sold to Czech subjects; for example, Poldi Kladno to Bohemia Art controlled by Mr. Stehlík or Škoda Plzeň to Mr. Soudek. Most of these sales did not end successfully and the companies went bankrupt. It is questionable whether such privatization brought new management to the enterprise, but what it certainly did not bring was the new capital. On the contrary, this form of privatization meant privatization on credit. The only group who had some savings was the nomenclature of the previous regime and criminal structures—after 1989, no one was going to give the property to these people. This left the new owners with only one choice—the money for the purchasing of the enterprise had to be borrowed.⁶² Amounts were huge⁶³ and the enterprises were thus burdened with debts that had to be paid

by new owners.⁶⁴ Such debt often proved to be unmanageable due to low profitability of the acquired assets and consequently the entire enterprise went bankrupt. Moreover, this approach resulted in enormous problems for the banking sector, who were dragged—through these sales and the ensuing insolvency of their clients—to the path of growing volume of classified loans, which turned out to be one of the most problematic issues of the entire transformation. Moreover, there is no doubt that the whole process was time consuming, leading to pre-privatization agony, plus this method definitely provides more favorable environment for corruption than the voucher privatization.

The second alternative is in direct sales to foreign investors. Economically, this option is probably the most effective. New foreign owner is able to bring new capital and management, increasing the chance of the enterprise to adapt to new market environment. Enterprises would have clear owners, taking care of the enterprise. The state budget would have a new source of revenues.⁶⁵ However, this variant was, according to most authors early in the 1990s, entirely politically impassable (Holub 1996; Hrubý and Rudlovčák 2002; Klaus 2001a). The left criticized any such effort as the cheap sale of “family silver.” The general mood was hostile against such measures (see Table 7.7).⁶⁶

Table 7.7: Answers to the question:
“Should foreign companies have
an entirely open field for activity?”
 (“fully agree” percentage)

May 1990	17.1
December 1990	22.5
June 1991	19.3
December 1991	15.9
June 1992	16.6

Source: Večerník (1993).

Economists were also hostile toward foreign capital:

It is vital that Czechoslovakia may enter in relations with its partners in unified Europe as an equal entity. Strong national capital is essential for this purpose. A nation without corresponding resources does not have much chance of developing its national identity, culture and other unique areas of social life.

National property in Czechoslovakia is mostly owned by the state. Its privatization within the frame of national economy is practically impossible, because the citizens do not have accumulated financial savings. The only viable method of privatization of national property is its sale to foreign investors (or fusion with stronger partners). Long-term results of such measure, however, could be lamentable. (Choulík et al. 1990)⁶⁷

Many were convinced that Czech enterprises were in a relatively good shape and did not need a foreign owner. The society did not admit that the family jewels were in worse condition than it imagined. The government did not favor sale abroad either and it adopted the Czech way as the expression of the efforts to maintain ownership of privatized enterprises in Czech hands.⁶⁸ For the sake of argument, let us imagine all political obstacles were overcome and the option of sales to foreign capital was realistically considered. What percentage of Czech property would really attract anyone abroad? Lavigne estimates it at maximum 10–15 percent of enterprises (Lavigne 1999).⁶⁹ Češka maintains that it is a myth that “if we waited for foreign capital, we would live to see it coming and privatization would proceed better and more happily (foreign and domestic generals after the battle, in which they loudly protested against selling the country to foreigners)” (Češka 2003). Similarly, Myant writes that foreign partners were not interested in most of Czech industry (Myant 1997).⁷⁰ Heavy industry was particularly disappointed—foreign partners wanted to buy only selected portions of mammoth Czech conglomerates; for example, Siemens in Škoda Plzeň. Automotive industry thus remained one of few success stories.⁷¹ The proposed procedure to privatize large conglomerates that would function similarly as Škoda Auto appears to be problematic as well (Mládek 2002). Such considerations were likely to be confronted with the lack of interest by potential buyers.⁷² Conversely, Vrba, the minister of industry and trade in the Czech government in 1990–92, argues that foreign investors expressed surprisingly strong interest in Czech enterprises in the early stage of transformation (Vrba cited in Žák 2004). He corroborates his claim with the example of the Mercedes Benz, who were interested in buying Tatra Kopřivnice. Vrba claims that Klaus was against, because the Mercedes wanted the same advantages as Volkswagen in Škoda and, besides, Klaus needed renowned enterprises for voucher privatization for political reasons. Vrba also maintains that the Czech ministry of industry and trade chose thirty-three enterprises for which it looked for strategic

foreign investors. The plan was even adopted by the Czech government, but it was not implemented.⁷³

It should be noted that not all sales to foreign owners were successful—for example the sale of ČSA to Air France, IPB to Nomura, Tatra Kopřivnice to various foreign firms, and Aero Vodochody to Boeing all ended in a fiasco.⁷⁴ Foreign owners do not guarantee enterprise prosperity. In any case, even this general option has some negative aspects. Time is of the essence: how many years would sale of hundreds of enterprises take? Then there is the prolonging of preprivatization agony, the tunneling and stealing of assets from the enterprise. And there is still another possibility—the foreign owner buys the enterprise and closes it to get rid of competition. The inflow of new capital into the enterprise was not guaranteed either, because the new owner would have to pay for the enterprise and would certainly want his money back as soon as possible. The space for corruption, like in the previous option, would be huge. The owner would probably restructure; in other words, he would close ineffective parts of the enterprise and lay off redundant employees. Higher unemployment would spawn critics who would criticize high unemployment. If 15 percent of property were sold, it could certainly help the economy and its restructuring, like it did for example in Škoda Auto. But it would hardly be an ingenious approach for saving the entire economy. Only the best bits would have been sold and the state would have been left with property that nobody wanted.

The third option under consideration was spontaneous privatization—enterprise takeover by its managers. It was not a popular method, but we should consider it as an option as it had its advocates (for example, Bauer 1993). Government economists were afraid of using it, as it happened early in the 1990s in Hungary and Poland (Klaus 2001a). Consequently, political support for the transformation process as a whole suffered a huge blow, because people were unhappy with the fact that the enterprises were handed over to the former management under strange circumstances.⁷⁵ The procedures were problematic and the management took out assets from the enterprises—something called “tunneling” in Czech conditions. It did not bring new capital to enterprises either. Whether the managers would start restructuring is questionable; were they capable of doing so if they had spent their lives in centrally planned enterprises and were promoted to their positions for their political engagement, rather than their skills? Yet it is true that the companies would have a real owner, who would probably take care of the enterprise—or

rather of the parts taken out of it. Spontaneous privatization would not be clean or just in any sense. Former communists who were in leading business positions during the political change would have had a huge advantage. Such a process would be politically unpopular.

The last option is the mass application of employee shares. This method was very popular among leftist politicians and economists—namely Miloš Zeman.⁷⁶ The idea was that the employees who take control of the enterprise will manage it more effectively, because they have a stake in its prosperity (for example, Choulík et al. 1990). The idea comes from the systems of employee shares in the United States and several Western European countries. However, the government economists did not agree with these proposals for several reasons. First, such an approach was perceived as a reminiscence of collective ownership and self-managed socialism, that was applied in Poland and Yugoslavia, an idea not particularly dear to the government. Second, the employees who happened to be employed by profitable companies would be in better positions, and the state would have to make settlement with the people who were employed in nonprivatized institutions and enterprises. Jonáš points out possible problems stemming from the lack of trust of banks toward such companies, short-term horizon of their decision making, and so on (Jonáš 1994).

The main question is what would be the interest of owners-employees. Would they like to carry out painful restructuring, close plants, and lay people off? I doubt it. Would the method bring new capital or management to the enterprises? Certainly not. The result would probably be the same as in similar autonomous enterprises in Poland or Yugoslavia before political changes—the management pandering to employees. However, corruption-wise, the method appears to be quite clean. The last question is whether the employees would be interested. It was possible to use employee shares in privatization,⁷⁷ but the interest was weak (see Table 7.8).

Table 7.8: Will you buy the shares of the enterprise in which you work?

	Yes	No	I do not know, not employed
November 1991	25.4	60.1	14.5
January 1992	9.9	71.1	19.0

Source: "Trendy & Trhy" (1992).

Let us sum up the previous analysis. It is clear that there is no miraculous method, solving the privatization puzzle. It should also be clear now that all approaches had positive and negative aspects. It was impossible to evade the costs. Experience of other transforming countries is identical, because privatization was not problem-free anywhere (Loužek 2005). I have a feeling that those who criticize sometimes forget that the state share in the Czechoslovak economy in the early 1990s was quite exceptional (certainly not 20 enterprises as in Britain) and therefore “standard” methods could hardly have been used. For my assessment of individual alternative approaches to privatization, see Table 7.9.

Table 7.9: Analysis of alternative privatization methods

	Real owner [*]	New capital	New management	Process purity ^{**}	preprivatization agony ^{***}	Restructuring ¹	Political support	Process justice ²	Direct fiscal revenue
Voucher privatization	4	5	4	1	2	4	1	4	4
Direct sale to foreign inv.	1	3/?	1	4	5	1	5	3	1
Sales to domestic inv.	1	5	?	5	5	2	4	2	2
Spontaneous privatization	1	5	5	5	1	2	5	1	5
Employee shares	4/?	5	4/?	1	3	5	2	1	4

Scale from 1 to 5, where 1 means certainly yes, 5 certainly not, and ? means the result is difficult to guess

^{*}someone who will act as an owner, trying to maximize profits

^{**}danger of corruption: 1—very high; 5—very low

^{***}process pace: 1—very fast; 5—very slow

¹quickness of initiation and intensity of implementation: 1—very fast; 5—very slow

²chances for insiders: 1—very high; 5—very low

7.3.3 Dispute about the mass privatization as a whole

What is the assessment of the Czech mass privatization as a whole? I fully subscribe to the time development of opinions about privatization (see Loužek 2005). He observes that in the first stage, the Czech privatization was perceived very positively both abroad and at home. Then came the period after monetary turbulences in 1997, when the privatization (and transformation

as a whole) was damned. Loužek asks, whether the time is right in 2005 for a more objective assessment of the entire process. What were the opinions about privatization? The criticism of its methods focused on several areas—the possibility to steal corporate property, ensuing weak execution of property rights, and weak performance of privatized enterprises (the latter two aspects are usually related to voucher privatization). I will now concentrate on the issue of stealing, selected specific opinions about privatization and finally on the global assessment of the entire process.

The fundamental criticism of privatization focused on the stealing of property (Klusoň 2004; Mlčoch 1997; Orenstein 2001),⁷⁸ which accompanied privatization and which was the result of weak institutional environment. Part of this criticism is directed towards the behavior of the IPFs. Reformers naturally disagree (see, e.g., Češka 2002; Dlouhý 2003; Hrubý 1999). Holman notes that stealing was occurring mainly during the pre-privatization agony (Holman 2004). Opinions defending Czech privatization are also to be found abroad; Fawn even claims that Czech privatization in general is considered to have been more legal and cleaner than in other Eastern European countries (Fawn 2000). Even those who criticize the process quote only a few corruption scandals (e.g., Orenstein 2001). Klaus compares privatization to a highway—accidents happen, but nobody wants to shut the highway down and nobody equates accidents with the total failure of road traffic (Klaus 1994). He also says: “the state should define privatization rules and make sure they are observed. However, no rules are and will ever be absolutely perfect, and nobody can prevent all intentional offences, or unintentional accidents.” He then specifically differentiates between intentional frauds, which he believes were sporadic; errors and mistakes of those who managed the privatization, as errors are bound to happen; and complaints of unsuccessful bidders.

Besides the aforementioned criticism of stealing, other aspects are occasionally criticized as well. Kukačka complained of low sale prices, blaming credit restriction (Kukačka 1996).⁷⁹ Čermák claims the opposite—that the prices were too high (Čermák 2000).⁸⁰ Tříška writes that privatization is an expensive, not a profitable, process (Tříška 2002). Its strategy therefore emphasizes minimization of expenses, not maximization of profit or even only revenues. Dobešová perceives privatization as unsuccessful, because property rights were not executed effectively and restructuring did not happen (Dobešová 2000). However, this issue relates to voucher privatization in particular, where I discuss it in more detail. Češka writes that privatization failed

where courage was missing, for example with banks or telecommunications (Češka 2003).

Advocates of reform in general pinpoint positive characteristics of the process. Kotrba praises the fact that privatization into the hands of management was prevented and that the Czech privatization provided room for competition (Kotrba 1997). At the same time he believes it was not as quick and simple as initially imagined, especially because the number of methods led to demanding and time-consuming decision making. In Czech privatization, property was not sold to those who had money—proponents of the previous regime and foreign subjects (Fawn 2000). Cases of “crony” capitalism or “nomenclature privatization” (commonplace in other post-communist countries) were isolated. He also observes that the Czech model did not pander to pressure groups and special interests of insiders, but rather relied on the support of the population. He perceives the process as open and competitive. Similarly Desai and Plocková express their admiration of the pace, scope, and justice of the privatization process in the CR (Desai and Plocková 1997). Češka believes that it will take a long time before the radical denationalization, which took place in the Czech Republic, is fully appreciated (Češka 2003). Fawn realistically writes that the Czech privatization was neither a myth nor a miracle, but it contained elements of both (Fawn 2000). Similarly, Hrubý maintains that Czech privatization was honest and fair (Hrubý 1999). Finally, Weigl writes that the Czech privatization led to a situation when, in a very short time, mammoth state-owned and hopelessly backward enterprises were transformed to standard companies, and modern economy with tens of thousands private enterprises exporting to the most advanced markets with the highest added value emerged (Weigl 2003).

My opinion is that the fundamental mass privatization was truly fast and fairly successful. Critical voices pointing out related criminal activities are certainly justified, but such cases were relatively isolated with the exception of the privatization investment funds. I agree with Klaus when he says that privatization scandals with such huge property transfers were unavoidable (Klaus 1994). Other transforming countries had similar experience—privatization without a scandal never happened and it seems that Fawn is right in claiming that privatization in other countries was substantially more problematic than in the CR (Fawn 2000). We should always bear this in mind, and we should also ask about alternatives. The success of the entire process is depicted in Table 7.10.

Table 7.10: EBRD index of small and large privatization, 1991–2004⁸¹

	1991	1992	1993	1994	1995	1996–2004
Small Privatization Index	3.0	4.0	4.0	4.0	4.0	4.3
Large Privatization Index	1.0	2.0	3.0	4.0	4.0	4.0

Small Privatization Index: 1—small progress; 2—substantial share privatized;
3—nearly complete privatization program; 4—total privatization of small enterprises;
4+—standard typical for advanced economies.

Large Privatization Index: 1—small percentage of private enterprises; 2—privatization program nearly prepared and some enterprises privatized; 3—over 25 % of large enterprises in private hands;
4—over 50 % in private hands and substantial progress in management of enterprises; 4+—over 75 % of enterprises in private hands and standards typical for advanced economies.

Source: EBRD (2000, 2004).

7.4 Privatization after 1995

Privatization continued after 1995, but its tempo slowed down, especially because most of the property was already in private hands. Another reason was the decreasing support for the entire process. The used methods changed as well—direct sales became more widespread. Ownership concentrated in this period as well. Privatization process was revived after 1998 when the social-democratic government came into power.

7.4.1 Privatization as such

Privatization progress after the end of the second wave was rather cautious.⁸² The main applied method was direct sales in tenders. The state kept significant shares in banks, telecommunications, as well as gas and electricity companies. Foreign buyers played a much more significant role in this period (see Table 7.11).

In 1994, part of Telecom had already been sold to Tel Source. However, other major sales were delayed especially due to political disagreements. After 1995, the residue share of the state in voucher-privatized companies was hardly decreasing anymore (Kočenda and Lízal 2002). Early in 1999, the state maintained its share through the FNM in 369 companies with the total market value over 440 billion CZK (accounting value of the state share was nearly 177 billion). This leads to the conclusion that removing the state

influence was unsuccessful.⁸³ Nevertheless, the Ministry of Privatization was formally dissolved in 1996.

Table 7.11: Participation of foreign capital in privatization and FDI (in %)

	Period	CR	Hungary
Share of privatization revenues in foreign currency in total privatization revenues	1990–96	15	63
	1997–99	80	40
Share of privatization revenues in foreign currency in total foreign direct investment	1990–96	80	47
	1997–99	50	20

Source: Srholec (2001).

It is somewhat surprising that a new impulse for sales came with the victory of Social Democrats in 1998 elections. The new government was under growing fiscal pressure and it was forced to privatize. It succeeded for instance in privatizing all banks. It was less successful with other large companies. Weigl quotes examples of failed major privatization projects in 2001 and 2002 (Weigl 2003). The government did not succeed in privatizing for example Telecom, Unipetrol, or ČEZ before Czech entry into the EU. Loužek notes that the main reasons involved exaggerated prices and poor organization (Loužek 2003). The last major privatization before accession to the EU was the sale of Transgas RWE to Gas AG in 2002 for 117.3 billion CZK (*HN 2003 Yearbook* 2003). Holding Vítkovice and Škoda Holding were sold the following year. As an example, I describe the development of attempts to sell Tatra—a lorry producer—in BOX 50.

Generally, the progress of privatization under the social democratic government can be demonstrated by the following numbers. The government owned shares in thirty-eight strategic companies at the end of 1999, in twenty at the end of 2002, and in just seven companies at the end of 2004 (FNM 1999, 2004).

BOX 50 Privatization of Tatra Kopřivnice

Tatra was a famous Czech car producer. The company was founded already in 1850 in a small Moravian town of Kopřivnice. It produced one of the first cars in Central Europe in 1897. During the communist reign the company mostly concentrated on production of lorries and became the biggest world producer

of the off-road lorries—producing 15,000 machines per year in the 1980s (Myant 1997). The production of personal vehicles was limited to a small number of luxury cars for communist leaders. The company employed more than 15,000 persons in 1990.

The collapse of the eastern markets had a direct and cardinal impact on the company; the Soviet Union used to be the main market for the lorries. The production sharply dropped to 6,000 lorries in 1992 and since 1994 has not exceeded 3,000 pieces per year (Leko 2009). Not surprisingly, the company had financial problems. Foreign investors (Mercedes) were interested in the company but required the same conditions as Volkswagen was offered in Škoda Auto. The Czech government supported the idea but the federal government wanted/needed attractive companies into the voucher privatization. In the end, 96 percent of the shares were distributed in the voucher privatization. The shares were mostly gained by banks' investment funds but none of them were able to keep control of the company. In 1993, US management (GSR Inc.) was invited to rule the company and got 15 percent of the shares. The manager in charge was Gerald Greenwald who was famous for saving Chrysler at the beginning of the 1980s. The US managers were not able to reduce staff numbers for inner resistance and possibly because of their way of management that was described as "management by fax" (Myant 2003). The management did not fulfill the expectations and left the company after a year. The situation became highly problematic in 1995—the production declined to just 422 lorries but there were still 7,500 employees in the company and 4 billion in debts. The company did not pay its suppliers. The commercial banks were still willing to support the company—possibly under government influence or because of their own involvement.

Then a potential saviour appeared. It was believed to be Škoda Plzeň that was controlled by Lubomír Soudek, who purchased 43 percent of the company in 1996. Soudek says that he was forced by the banks to make this acquisition. Regardless of it he was able neither to find new markets nor to solve huge debts. Komerční Banka decided to stop lending to the company in 1996. The management together with creditor banks submitted to the government a plan for restructuring in 1997. But the expenditure of 3.5 billion crowns was not approved by the government. The situation was worsening and Soudek sold its share back to the government in 1998. The circumstances in 1999 were critical and the company was on the brink of bankruptcy. The production had

to be stopped at the beginning of the year and employees were paid only 60 percent of their wages (Konsolidační Banka 2000). The company still had 3,800 employees. The management was not able to find financing for production. The government again gained a majority ownership in the company.

The social democratic cabinet incorporated the company into the Revitalization Program to subsidy large companies in 1999. The information about general help by the government is confusing. The Consolidation Bank provided at minimum 2.8 billion crowns. Plus there was money from the Revitalization Program itself (it reached 8 billion for all the companies in the program). Moreover, there were unclear property transfers. Due to it I am not able to estimate the overall subvention.

The company was after its restructuring sold to SDC International in 2001 for 1.152 billion crowns. In 2003, the majority share was obtained by a US company Terex International. The economic results in the following years were problematic. In addition, Ronald Adams, the company's boss, was in 2012 accused of corruption for an attempt to influence purchase of 588 off-road lorries for the Army in 2008. He was cleaned from any accusation in 2013.

.....

7.4.2 Changes in ownership structure

Ownership structure resulting from privatization, especially voucher, was problematic and frequently criticized by economists. Simonson, for example, writes that, in reality, enterprises were owned by managers, funds, and the state, and none of them was interested in real restructuring (Simonson 2000). In the second half of the 1990s, the situation began to change with the concentration of ownership. This wave peaked in 1996 and 1997 and it is sometimes referred to as the so-called “third wave” of privatization. It consisted in the buying out of shares from small investors and funds in the effort to acquire majority in the enterprise and to sell it to a strategic investor. The “wave” was related to the activities of Harvard Funds and Motoinvest investment groups (Myant 2003).⁸⁴ The latter group, for example, managed to acquire a substantial share in Česká spořitelna Bank and Česká pojišťovna insurance company, and got real control of Agrobank. Most politicians were publicly against this activity, although concentration was what they strove for (Fuchs 2002). Motoinvest was formally disbanded in July 1997.

The “third wave” was caused by several factors. One was the 1997 law on investment companies, which forced them to open—that is to buy their own shares from shareholders. As a result, many investment groups reacted by changing their ownership structure to holdings, which were exempt from the tougher rules. The investment groups which did not undergo this change were forced to acquire liquidity and therefore sold the corporate shares they held. Pavlínek maintains that the certain lawlessness that resigned in companies was temporary, and the situation in the second half of the 1990s began to change (Pavlínek 2002). He claims that the funds realized they were incapable of managing the enterprises effectively and decided to sell their shares, resulting in consolidation of ownership. The consolidation result was that before the end of 1995, 800 out of 1,849 enterprises privatized in voucher privatization had a nongovernmental majority owner, and the rest had a specific owner before the end of 1997 (Desai and Plocková 1997).

7.5 Privatization results

Opinions about the volume of privatized property vary and there is no single unified statistic. Before 1999, property in the accounting value of 780 billion CZK was privatized (Holman 2000). Individual methods were represented as follows:

- small privatization—45 billion
- free transfer in voucher privatization—shares for 333 billion
- restitutions—25 billion
- free transfer from state to municipalities and local authorities—121 billion
- standard methods—121 billion

In the 1990s, the budget revenues from privatization amounted to approximately 2 percent of GDP (*HN 2001 Yearbook* 2001). However, privatization did not stop at the end of the 1990s. The total volume of privatized property since the beginning of privatization is expressed in the following table and graph. Table 7.12 shows that the most frequently used privatization method was the transfer to joint-stock company (see also Figure 7.2).

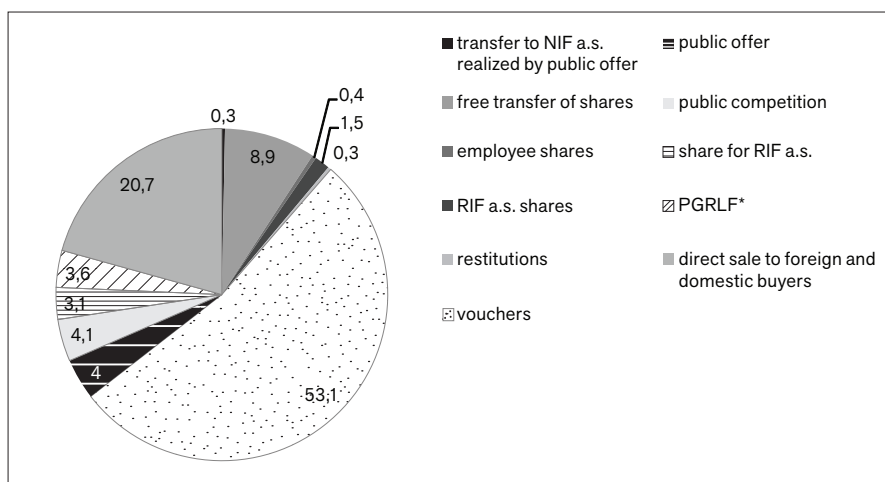
Table 7.12: Privatization in the CR classified by transformation methods in 1991 and 2003

Transformation method	Handed over (number of projects)	% of total projects	Property (thousands of CZK)	% of total property	Finished (number of projects)	Property (thousands of CZK)
Public auctions	1,210	7%	8,495,341	0.9%	1,204	8,443,604
Public tenders	1,411	9%	34,086,439	3.5%	1,382	33,519,385
Direct sales	6,817	41%	70,444,456	7.1%	6,698	69,314,967
Free transfers and restitutions	5,301	32%	72,823,002	7.4%	5,260	72,000,049
Transfer of state enterprise to Inc.	1,553	9%	580,817,184	59%	1,553	580,817,184
Transfer of Inc. to Inc.	321	2%	217,516,939	22.1%	321	217,516,939
Total	16,613	100%	984,183,361	100%	16,418	981,612,128

Note: A handed-over project means a project, in which the government of the Ministry of Finance passed a decision on privatization, and the FNM took it over for implementation. Terminated privatization project is a project, for which a sale contract was signed (or a contract on free transfer of property/shares) or for which an auction was brought to an end.

Source: National Property Fund of the Czech Republic (2004).

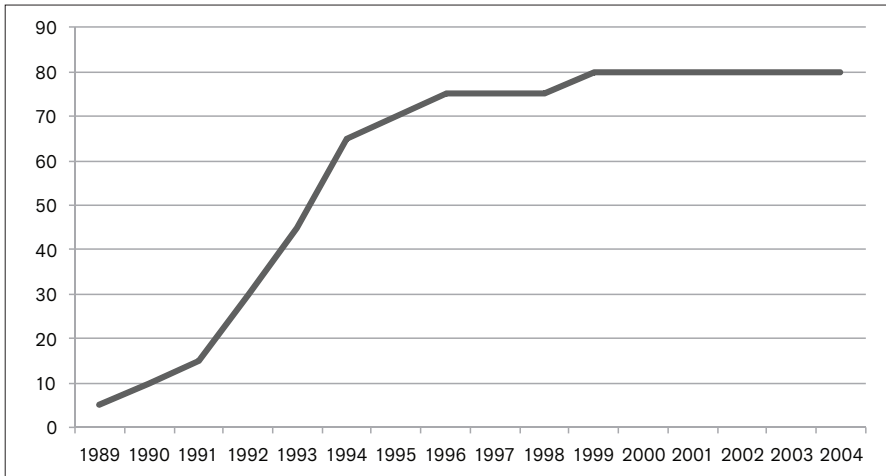
Figure 7.2: Forms of privatization of shares since the beginning of privatization until the end of 2003 (in % of nominal value)



*PGRLF – Farming and Forestry Relief and Guarantee Fund, Inc.

Source: National Property Fund of the Czech Republic (2004).

Figure 7.3: Private sector share in GDP (in %)



Source: EBRD (2008).

The result of privatization was a larger share of private sector in the economy. Dillon and Wykoff, otherwise critical of the Czech approach to privatization, maintain that in 2000 the CR had, together with Hungary, the highest portion (80 percent) of property in private hands of all transitive countries (Dillon and Wykoff 2002). The development of nongovernmental sector is displayed in Figure 7.3.

The following table reveals that the most important denationalization factor was the mass privatization in the early 1990s. The privatization process slowed down in the second half of the decade, but it was later revived by the social democratic government. The mid-1990s witnessed the process of ownership concentration, resulting in the situation in which each company had a specific owner.

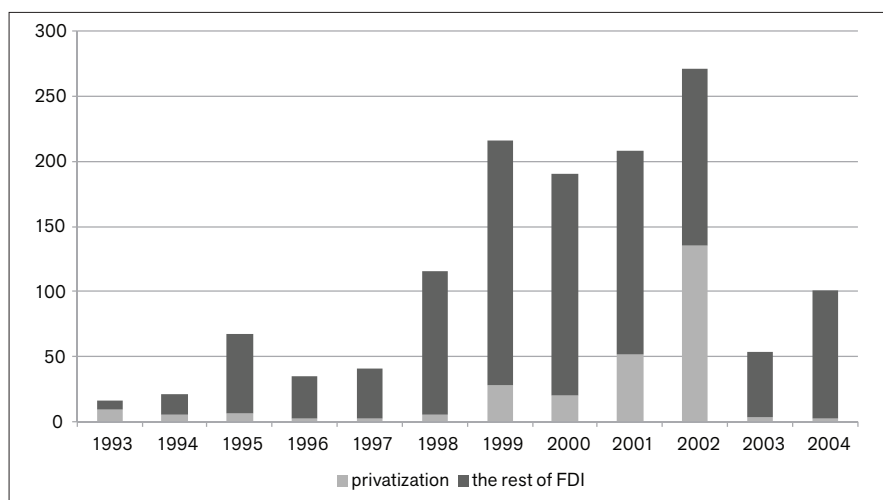
The administration of privatization had its financial costs as well. The costs were mostly burden of the FNM. We can see the development of the costs in the following interesting table. The average costs per unit were by far the lowest at the beginning of the transformation process when the VP was applied, and the highest costs were recorded at the turn of the century when the banks were sold, which was accompanied by high administrative costs.

Table 7.13: FNM budget and costs of privatization, 1991–2004

Year	Budget of FNM in mil. CZK	Costs of realization of privatization projects	Number of FNM employees	Finished privatization projects	Finished units	FNM costs per privatization project (in millions of CZK)	FNM costs per privatization unit (in millions of CZK)
1991 (IX–XII)	8.5	—	—	—	—	—	—
1992	29.1	—	45	674	2,769	0.0432	0.0105
1993	99.5	—	n.a.	922	1,904	0.1079	0.0523
1994	181.0	—	233	818	3,144	0.2213	0.0576
1995	197.9	43.1	306	1212	2,218	0.1633	0.0892
1996	413.5	263.0	309	1211	2,537	0.3363	0.1605
1997	321.4	167.6	299	825	1,679	0.3896	0.1914
1998	292.6	152.2	267	400	923	0.7315	0.3170
1999	590.8	442.0	247	60	175	9.8467	3.3760
2000	532.8	374.0	253	51	79	10.4471	6.7440
2001	729.2	576.4	231	42	95	17.3620	7.6758
2002	755.7	616.9	198	120	182	6.29.75	4.1522
2003	206.5	66.4	143	43	81	4.80.23	2.5494
2004	204.2	62.1	125	52	81	3.9269	2.5210

Source: Ježek (2006).

Figure 7.4: FDI and privatization in the Czech economy (in billions of CZK)



Source: Fond národního majetku (2005).

Privatization revenues also created an important part of FDI inflow into the country. They reached more than 50 percent of the inflow in some years. One of the estimations of the share of privatization income on FDI is depicted in Figure 7.4. But I must personally admit doubts about some of these numbers especially at the turn of the century when the banks were privatized. I think that the share of the privatization revenues should be higher.

There was no silver bullet to privatize public property devastated after fifty years of totalitarian regimes. The government relatively quickly stepped back from the economy and the share of private ownership increased. The pace of the privatization at the beginning of the 1990s was really quick. The first wave of privatization that concerned 1,491 companies in the value of USD 10.7 billion and 8.5 million inhabitants took place in fourteen months (Shafik 1993). It was an equivalent of privatizing of more than three middle- and large-size companies per day. The government mostly gave the property away. The proportion between property that was sold and given to the inhabitants was 34:66 in 1994 and 39:61 at the end of the transformation (Ježek 2006).

There was much criticism of the privatization process. The critics targeted at the methods and pace of privatization. I can understand certain disillusionment of the public because the process definitely brought winners and losers. Everyone has the right to express his or her view of this topic. But I would like to read a constructive criticism that would suggest meaningful alternatives. I am afraid that critics (if they have any alternative proposal) usually forget about the drawbacks of their suggestion. In my view, there was no perfect solution and the selected alternative was well justified.

The most visible mistake in the privatization process was, in my opinion, the setting of the rules for investment privatization funds. We will never know if it was just a mistake or an intention of the lawmakers. But I am personally convinced that the reformers were not interested in their personal material enrichment in the privatization. To put it differently: if I wanted to steal public property during privatization, I would definitely not opt for anonymous and enormously broad voucher privatization where the property is given to inhabitants. I would decide for case by case privatization into the hands of my friends or someone who provides financial compensation for my involvement. I think that the reformers' motivation was different—foremost it was a highly exciting job—something that most economists dream about and do not get a chance to do. And they, in my view, truly believed that private property is better for the economy and society than public one.

Notes

- ¹ Some economists even organized a petition against restitutions (Mlčoch 2000a).
- ² The report further claims that “based on the restitution laws, property nationalized in 1955–1959 was returned in the first phase. It involved over 70,000 apartment houses and houses with rentable rooms, used mainly for small stores, services and other small businesses. Besides, the restitution program for the property nationalized in 1948–1955 was expanded to agricultural property and land, making it possible to return approx. 30,000 industrial and administrative objects and almost 50 percent of state owned forests, agricultural property and land.”
- ³ For example in agriculture, 50 percent of state farms and numerous cooperative farms had to be returned to original owners (Holub 1996).
- ⁴ There was no formal limit on the size of sold property; the largest unit (Stama Bzenec) was sold at an auction for 305 million CSK.
- ⁵ The members of the privatization commissions and their relatives could not take part in the auctions anywhere in the whole country.
- ⁶ Ježek notes that Dutch auctions are used in the Netherlands in flower auctions—flowers spoil quickly and therefore the auction starts with extremely high price and goes downward (Ježek cited in Husák, 1997).
- ⁷ At this time, abuse through Dutch auctions was often alleged, with provable case where participants agreed on a Dutch auction in the effort to decrease the put-up price (Klvačová and Buchtiková 1992). But in most cases the reason was the real lack of interest in the given object for the price.
- ⁸ Lavigne mentions unofficial participation of foreign investors in Czechoslovak small privatization (Lavigne 1997).
- ⁹ Fawn notes that the very first shop sold was a greengrocery (Fawn 2000).
- ¹⁰ Prices depended on the territory.
- ¹¹ Total revenues in the entire Czechoslovakia amounted to approximately 45 billion (for example, Švarcová 2000).
- ¹² Klvačová writes about complaints of investment funds after the first wave of voucher privatization against the FNM (Klvačová 1994b). The funds complained that the FNM refused to take responsibility for the companies although it owned for example 100 percent of shareholders’ rights for a year. It restricted activities in the companies it was supposed to manage, prevented them from selling or renting redundant property, but refused to assume responsibility for ensuing losses. Moreover, it allegedly sucked all free financial resources from the companies before transforming them to joint stock companies.
- ¹³ Češka, who presided over the period of payments in arrear defends himself by claiming that the FNM privatized property worth almost 500 billion CZK, while underpayments amounted to approximately 5 billion (Češka 2003).

- ¹⁴ In 1990, the value of property designated for privatization was 1,400 billion CSK, while the savings and cash of households were only 323.4 billion (Fuchs 2002).
- ¹⁵ The government was afraid that the state-owned companies could sell their property. There was an article in the law that prevented it and respective companies had to ask the government if they wanted to sell anything, for example old lorries. Some of the companies tried to avoid it by renting the property, often to a company connected with an employee. Consequently, the parliament amended the law to prevent it (Ježek 2006).
- ¹⁶ Liška claims that such revenue would constitute an expense to private sector, while the goal was the opposite—to transfer the assets to the private sector (Liška 1996).
- ¹⁷ This topic is closely related to disputes about the restructuring of companies; to alternative approaches to privatization; and to the development of institutions.
- ¹⁸ A case-by-case approach is usually considered as a “standard method,” used for example in Great Britain.
- ¹⁹ For the sake of comparison, Britain privatized only twenty companies in ten years, producing approximately 5 percent of total added value (Commander, Coricelli, and Stähr 1995).
- ²⁰ Sommer and Tůma are similarly skeptical about the long-term path (Sommer and Tůma 1999).
- ²¹ Frydman, Rapaczynski, and Earle write that up to twenty to thirty competing projects were sometimes submitted for a single company (Frydman et al. 1993). A maximum of 126 projects was submitted for Lacrum Brno. A single subject frequently submitted several projects, because the priorities of the ministry were not transparent (Dobešová 2003).
- ²² Competing submitters had certain knowledge of the management plan (Kotrba 1997). Ježek writes that one of the reasons why the deadline for privatization had to be prolonged was that competing submitters had to have a chance to get information about the company, but the management prevented it (Ježek 2006).
- ²³ The process was occurring on the level of individual republics. Sacks (1993) says that the federal government was responsible for only 5 percent of privatization sales.
- ²⁴ Ježek mentions that only 10 percent of the projects were without mistakes (Ježek 2006).
- ²⁵ The author claims that many managers proceeded in this way, because they proposed the absolute majority of shares (over 95 percent) to be offered as vouchers and thus practically threw away the chance to acquire the property directly.
- ²⁶ Kotrba believed that at least 10 percent of managers used this approach (Kotrba 1997).
- ²⁷ Kotrba maintains that the most frequent method was the direct sale to preselected applicant (Kotrba 1997).

- ²⁸ For more on the legal framework of privatization, see Plíva (1991).
- ²⁹ However, Ježek was in favor of direct sales even at this time (cited in Klvačová 1992a).
- ³⁰ Klaus notes that they tried to prevent this situation from happening. They wanted the enterprises to be in the phase of joint-stock company “just for one minute,” in a purely formal interim state, during which nothing was supposed to happen. They were afraid the companies would “scatter” their property (i.e., property would be taken out), which later did occur anyway (Klaus 2001).
- ³¹ Škoda Auto and Škoda Plzeň are two different companies that are not interconnected in any way.
- ³² The issue of the Czech way is closely related to inflow of foreign capital.
- ³³ Myant writes about the Czech way in the context of delayed privatization of banks (Myant 2003).
- ³⁴ For an interesting insight in the events in the Škoda Company controlled by Soudek, see Hudec (1999).
- ³⁵ Owing to bad condition of companies, the accounting value was often higher than the audited value, therefore domestic subjects often used audits to evaluate the property (Kotrba 1997).
- ³⁶ These economists conceived the Czech version, not the voucher privatization concept itself. First mentions of the application of the voucher method in Czechoslovakia date back to Koloděje negotiations in February 1990.
- ³⁷ Bokros affirms that there were political reasons for the voucher privatization, namely the attempted coup in the USSR in 1991 (Bokros 2001). It aroused concerns in the CR, where the Russian military was still present, but not in Hungary. Ellerman brings another extreme opinion; he believes that the reason for voucher privatization was the effort to get rid of the old reformers who wanted to use decentralized methods, such as workers’ councils (Ellerman 2001). He claims the voucher method was a brilliant strategy of turning decentralization backwards and returning the power to the state, so that the economic power could be given to “the right people.” He seems to forget that there had been no decentralization reforms in Czechoslovakia, as opposed to Yugoslavia, Poland, or Hungary.
- ³⁸ Tříška however, maintains that the registration was fairly formal, because the bureaucrats in charge were not able to judge the quality of the project proposal and so the stricter conditions would only provide more room for corruption (Tříška 2002). But Ježek criticizes it and says that the funds did not meet even the elementary rules of the functioning of the financial sector (Ježek 2006).
- ³⁹ The so-called golden share gave the state the power to intervene in the operation of the company although it does not control a majority share.
- ⁴⁰ All shares had the same price in the first round—3 per 100 points. In the second round (and later), prices were based on the results of the previous rounds.

- ⁴¹ Orders were filed in post office subsidiaries.
- ⁴² This measure was motivated by the effort to protect small investors and forced funds to diversify their assets. However, it also made it difficult for the funds to act as majority owners and prevented originating of strong owners. Frydman, Rapaczynski, Earle (1993) maintain that if an investor had several privatization funds, he could own maximum 40 percent of the enterprise. This specification was criticized for example by Tříška (2002).
- ⁴³ In the first wave, investment privatization funds could not be cut by more than 20 percent. This measure was cancelled in the second wave.
- ⁴⁴ It is evident that the approach of excessive demand over supply, and excessive supply over demand was treated differently, as well as individual investors and funds. The reason was the will to strengthen convergence tendencies in the system.
- ⁴⁵ Roughly 3 million of DIKs were lured into the investment funds specific marketing methods, with the Harvard Funds being a prominent example (Tříška 2002).
- ⁴⁶ Voucher privatization method was used mainly for large companies and for the companies unattractive to foreign investors (Holman 2000). Moreover, standard methods were used to privatize smaller companies and companies, where entry of foreign capital was likely (Češka 2003).
- ⁴⁷ Some investment privatization funds postponed issuing of their shares—the process took place between April 1993 and October 1994. Meanwhile, 20 percent of funds merged and four funds went bankrupt (Voucher Privatization Center 1995).
- ⁴⁸ The entire wave was a considerable technical success, because there were only 7,166 complaints, out of over 18 million invested vouchers (Voucher Privatization Center 1995).
- ⁴⁹ One hundred forty funds out of 218 from the first wave participated in the second wave.
- ⁵⁰ The whole issue of the VP is related to privatization alternatives.
- ⁵¹ Liška quotes an example of cross ownership, where “První investiční” (an IPB Bank daughter) owned 14 funds, including “Bankovní a rentiéřský fond,” which had over 50 percent of its assets in the banking sector (Liška 1996). For more on interconnection between bank funds and other banks, see Polouček (1996).
- ⁵² Schwarz claims the worst system fault of the VP was the participation of state-owned companies, mainly banks, who were in the position of new owners of the “privatized” property (Schwarz 2003).
- ⁵³ The two problems were intertwined.
- ⁵⁴ In the fall of 1994, the director of the Voucher Privatization Center, J. Lizner, was arrested with several million CZK in cash, supposedly paid to him to provide shares of Mlékárna Klatovy dairy. Lizner was sentenced to six years in prison for taking bribes and corruption. However, it remained unclear what it was that Lizner was supposed to receive the money for. Tříška notes that the ensuing investigation

proved that it was impossible to misuse the system the way it was set up (Tříška 2002). The guarantee consisted in the fact that entry into the system had no value for the intruder, as the information it contained was not helpful. Lizner claims he is innocent, but he has not been successful with request for a retrial.

- 55 For example, Pšenička, Léko, and Štětka wrote about a suspicious behavior of several commission members in the selection of adviser for the privatization of Czech Telecom (Pšenička et al. 2004).
- 56 Profits could have been enormous, especially if the investor sold his shares before the share markets plummeted. For example, in the first wave 220 shares of Škoda Plzeň could have been exchanged for 1,000 points (i.e., one voucher book; see Oswald 1994). At the exchange rate of 800 CZK per share in 1994, a single voucher book brought approximately 180,000 crowns. In 1996, the price of a Škoda share was still 1,000 CZK (Myant 2003).
- 57 Tříška maintains that the original VP was proposed without the mediators, that is without the IPFs (Tříška 2002). However, the argument that an ordinary senior citizen could not participate without it, eventually won.
- 58 The table does not say whether it includes daughter companies.
- 59 The FNM openly intervened only once, when it lowered the proposal of the banks for dividends in 1995 (Myant 2003).
- 60 For review of institutional environment, see Chapter 10 in this book.
- 61 By destructive criticism I consider intentions to discredit others opinion or procedure without providing any own alternative. On the contrary constructive criticism provides not only critique but an alternative opinion or procedure as well.
- 62 This approach is defended for example by Ellerman (2001). He argues that the lack of finances should have been bridged by loans. As banks were unable to meet capital requirements in such amount, the government should have become the creditor. In view of Czech experience in giving credit to companies (who rarely repaid the back) such attitude appears to be fairly problematic.
- 63 Let us recall that Čermák openly maintains that absurdity of these amounts in view of the property on sale discouraged foreign buyers (Čermák 2000).
- 64 Loužek writes that owners had to “suck out” their companies to be able to meet their obligations (Loužek 2005).
- 65 Myant writes that companies with foreign partners had the best chance for successful transformation (Myant 2003). Yet he admits that foreign owners could transfer production only to manufacturing companies without research or marketing. He believes it was correct that the state tried to help certain productions to survive due to national prestige.
- 66 Historical experience with foreign entrepreneurs also played a role (for example, Germans during World War II). Bienkowski quotes this factor to show that Poland

and Czechoslovakia shared similar attitudes (Bienkowski 1995). Fawn also mentions the fears of German influence (Fawn 2000). These fears were supported by the fact that German and Austrian companies played a dominant role among foreign investors.

- ⁶⁷ Authors recommended solving the situation through labor-managed enterprises.
- ⁶⁸ Regardless of this rather unfriendly approach, Sacks wrote that out of 1,700 large companies in the first wave of privatization in the CR, approximately 300 cases involved foreign buyers in privatization proposals (Sacks 1993).
- ⁶⁹ Janáček is skeptical toward views that foreign capital should have played stronger role in the Czech privatization (Janáček 2000). He claims it is unrealistic that the necessary 30–40 billion dollars could be attracted to the economy within two-to-three years. He also points out strong resistance of interest groups, trade unions, public majority, and even some liberal economists, who were all against the sale of family silver. Under such circumstances, he says it was a success that the government pushed through equal treatment of foreign capital, that is the principle of nondiscrimination. The attitude was modified only when the successes of foreign capital became too apparent. Similarly Liška maintains that foreign investors were not interested in Czech companies except for telecommunications, transportation devices and TV sets (Liška 1996).
- ⁷⁰ The condition of Czech enterprises is well illustrated by the example of the shoemaker Baťa, when his experts got acquainted with the condition of Czech shoe-making enterprises, they lost interest and wanted only the sales network consisting of approximately 200 shops (Simonian 1994).
- ⁷¹ Klaus notes that the recommendation of foreign economists (and especially foreign advisors) to sell to foreign capital is quite logical, because they were “rather well paid for it” (Klaus 2000a).
- ⁷² Mládek specifically writes that: “If the state managed to privatize ten to twenty key companies using standard methods (Škoda Auto model), hundreds of other enterprises would profit like Škoda suppliers. Smaller enterprises could then have been privatized using classical methods” (Mládek 2002). Myant is much more skeptical to repeating of the Škoda Auto success and he says that a foreign company may help a single enterprise, but cannot transform an entire branch (Myant 2003).
- ⁷³ It is not clear from the text what the Ministry of Industry and Trade planned to do with the remaining nonstrategic enterprises (Žák 2004).
- ⁷⁴ Other examples include Dow Chemicals, which wanted to enter into Chemical Plants Sokolov. The company bargained and tried to lower the price by 30 percent. Consequently, the FNM withdrew from the contract (Ježek cited in Husák 1997).
- ⁷⁵ I should note that the Czech attitude toward the managers from the communist times was generally negative in comparison to for example Hungary (Earle et al. 1994).

- ⁷⁶ The president's advisors held similar views (see Tříška 2002). And these procedures were also recommended by Ellerman (2001).
- ⁷⁷ According to the business law, the main advantage of employee shares was the fact that the new owner (employee) did not have to pay full nominal value for the share (Nesnídal 1992). The law did not define any upper limit to the share of employee shares in the basic equity and in theory it was possible to issue only employee shares. Besides, there was a possibility of issuing the so-called priority shares for managers.
- ⁷⁸ This issue is also closely linked to institutional development (see Chapter 10 in this volume).
- ⁷⁹ This opinion is quite problematic, considering the developments in the banking sector.
- ⁸⁰ Similarly Vrba argued that sales to Czech subjects took place for absurd prices (Vrba cited in Žák 2004).
- ⁸¹ Compared to Czech results, large privatization index in Poland was only 3.3 in 2004. In Hungary, the index development was similar to the Czech one. These two countries were the leaders among the transforming countries.
- ⁸² Dobešová et al. maintain that it was widely expected the remaining shares in the FNM would be sold within five years (Dobešová et al. 2003).
- ⁸³ Two hundred ninety-one out of these 369 companies participated in the VP; four years after the end of voucher privatization, the FNM portfolio still contained 17.5 percent of the companies that were supposed to have been privatized. The accounting value of these 291 companies was 347 billion CZK (Kočenda and Lízal 2002).
- ⁸⁴ Pavel Tykač, the leader of Motoinvest, became another highly controversial entrepreneur of the transformation process. His business methods were deemed extremely aggressive.

BANKING SECTOR AND STOCK EXCHANGE

One of the most pressing problems of the entire transformation was the role and development of the banking sector. Banks are the spines of the market economy and their functioning is a key factor in transforming savings into investments. They function as the engine of the economy; well-functioning banks are able to accelerate economic growth. A well-performing banking system means that the costs of borrowing are low and companies are able to invest. On the contrary, banks can be seen as “a stumbling block” if they are not able to provide firms with capital that they need. In the transformation process, the banking system played even more crucial role because of the enormous demand for new investment.

In this chapter I sum up the situation in the banking sector in the late 1980s to demonstrate how the sector “functioned” in the centrally planned era. Then I concentrate on the development at the beginning of the transformation process. I mostly focus on the establishment of new banks as well as the arrival of foreign banks. I discuss the late 1990s Czech banking sector crisis, followed by the description of the healing of the banking sector by government transfers and by privatization of banks. Additionally, I shortly discuss the origination and development of stock exchange markets at the end of the chapter.

8.1 Banking sector before 1989

The Czechoslovak State Bank (SBČS) was established in 1950 as a hybrid of central bank, commercial bank, and investment bank (Mervart, 1998). SBČS fulfilled the role of a central bank by implementing a monetary policy, that

is issuing of banknotes and defining exchange rate policy, but it also ensured meeting of the state budget, regulation and control of wage development. At the same time, it behaved like a commercial bank and accepted deposits, granted loans, exchanged foreign currencies, and organized the system of payment. Its clients were enterprises, not households. This system is regarded as monobank in contrast to a two-tier banking system that is typical for market economies.

In addition to the SBČS, Czechoslovak banking market had a few players with specific roles. For example, the Živnostenská Banka, the largest Czechoslovak bank between the two World Wars, nationalized in 1945. Živnostenská Banka carried out foreign currency operations for private persons. It had a subsidiary in London, which took care of relations with foreign banks, it helped in carrying out foreign trade, and so on. Another bank was the Československá obchodní banka (ČSOB), established in the 1960s. Its major owner was the SBČS, but foreign trade enterprises held minor shares in it. The ČSOB ensured international system of payments with subjects on the CMEA markets (Jonáš 1998a). The banking sector was complemented by two savings banks—Česká státní spořitelna (ČS) and Slovenská státní spořitelna—that housed personal accounts and granted loans to individuals. Savings surpluses were transferred to the SBČS and the latter provided the money to enterprises as loans.

It should be mentioned that the enterprises were entitled to loans. The distribution of these loans was decided by a plan and the enterprises' ability to meet their obligations was not assessed. The result was an abundance of unpaid loans.

Even the communist regime realized the banking system was dysfunctional and it was decided already in 1989 that the banking sector would be transformed to a two-tier system. Three banks separated from SBČS on January 1, 1990—Komerční banka, Všeobecná úverová banka, and Investiční banka. The situation was difficult for the newly created banks. For example, Komerční banka inherited eighty-four branches in the Czech part of Czechoslovakia with 7,900 employees, only 10 computers, and 325 billion of credits provided to state companies and cooperatives (obviously without any collateral) out of which 85 percent would be classified as bad by contemporary standards (Janáček 2009).

Another interesting point of the functioning of the banking sector during the centrally planned period was behaving of households. Households

especially were unwilling or unable to borrow money. At the end of 1988 households kept 365.9 billion of reserves (savings—265.6 billion, cash—57.8 billion, and 42.5 billion in life insurance; Ježek, Hrnčíř, and Kerouš 1990). This translated to close to 23,000 crowns per person on average. But at the same time, the debts were only 45.2 billion of crowns, which amounts to roughly 3,000 per person or one month salary, which is a miniscule amount in comparison to the developed countries. This aspect changed only slowly in the following years.

8.2 Banking sector development at the beginning of the transformation

The development of the banking sector was relatively dramatic. The characteristic feature of this development in the first stage of the transformation process was a sharp increase in the number of new banks on the market. New types of banks appeared: small domestic banks, foreign banks, and special banks created by the government.

8.2.1 New banks

The number of banks on the Czech market since the launching transformation grew quickly. Both the foundation of new Czech banks and the entry of foreign banks played a role in this growth.

It was quite easy to establish a bank at the beginning of transformation—regulations were relaxed, and all that was needed in 1990 to found a bank was 50 million crowns (approximately USD 300,000). Yet only every tenth application was accepted (Myant 2003). The government and the central bank used this policy to increase competition on the Czech banking market.¹ These conditions later became stricter. In April 1991, a potential bank needed 300 million to come into existence, and 500 million crowns after 1993. In addition, other requirements for founding a bank were added to the process. Despite relaxed regulations to establish a new bank, the Czechoslovak banking market at the beginning of transformation was highly concentrated. See Table 8.1 for the distribution of deposits and loans.

Table 8.1: Share of commercial banks on total deposits and loans at the end of 1990

	% of loans	% of deposits
Komerční Banka	47.8	17.5
Všeobecná Úverová	20.1	7.9
Investiční Banka	14.6	8.3
State Savings Banks (Česká Státní Spořitelna; Slovenská Státní Spořitelna)	10.3	62.3
Other	7.2	4

Source: Jonáš (1997).

The main pattern of the borrowing and lending in the sector kept stable since the period of central planning. Table 8.1 clearly shows that Česká spořitelna (Savings Bank) was collecting deposits and other banks were lending. Small banks had weak capital backing and they were acquiring money by loans from large banks (especially Česká spořitelna) on the interbanking market (Matoušek and Taci 2002; see also Table 8.2).

Table 8.2: Volume of deposits in commercial banks at the end of 1995

	Deposits		Loans	
	billion CZK	%	billion CZK	%
Komerční banka	22.4	25.7	227.2	26.0
Česká spořitelna	294.7	34.8	118.7	13.6
Československá obchodní banka	83.4	9.6	80.9	9.3
Investiční a poštovní banka	139.4	16.1	128.9	14.7
Agrobanka	48.7	5.8	38.7	4.4
Other	75.0	8.8	279.7	32.0
Total	865.7	100	874.1	100

Source: Myant (2003).

As of January 1, 1996, it became possible to found and operate credit unions. The number of domestic and foreign banking subjects was growing. But the latter often limited their activity to the best clients—often foreign companies they knew from their home environments. Havel (2004) compares the expectations which accompanied the entry of foreign banks with the reality:

(Foreign banks) were supposed (according to initial expectations) to bring real competition to the banking market, but the expectations were not met. These institutions, equipped with good market experience, pounced on the

most lucrative segments of the Czech market—the clients representing the lowest risk.

This led to double pressure on the Czech banks—foreign banks “stole” the most valued clients—large municipalities, administrative or natural monopolies, and several of the most successful enterprises, and created price pressure toward the valued customers they still had. The Czech banks were thus left with the subjects with a high degree of risk and those clients who were outright insolvent (Havel 2004). However, foreign banks also brought capital and experience to the Czech market. Disputes about the volume of provided loans were also raging at this time. Table 8.3 shows the overall trend in the growing number of banks. This growth led to a decline in concentration of banks (e.g., Chmelík [1997] used the Herfindahl-Hirschman Index to measure this development).

8.2.2 Special banks

There was an exceptional group in the banking sector that consisted of special transformation institutions. The Consolidation Bank was one of them—it was established to accept obligations from the previous regime and bad loans in the era of the clearing of bank assets (see BOX 51). Another special institution is the Českomoravská záruční a rozvojová banka, established in 1992 by the state and the large banks. Its purpose is to support small- and mid-size enterprises through loans and bank guarantees. The third special bank is the aforementioned Czech Export Bank (Česká exportní banka), providing cheap loans for exporters. The state was the majority owner with 66.7 percent—the rest is held by the above mentioned Exportní garanční a pojišťovací společnost (www.egap.cz), also controlled by the state.²

BOX 51 Consolidation Bank

The Consolidation Bank (KoB) was established in February 1991.³ The situation was critical—one estimation calculated the size of classified debts in banks in 1991 to be 55 percent (Kaiser 1995). Loans for permanently turning stock in the amount of 80 billion CSK⁴ were transferred to KoB and then followed other bad assets from large banks. Simonson (2000) maintains that the KoB was supposed to force those whose shares it had to restructure or to announce bankruptcy, but it was not able to implement this plan into reality. Rather, it became a grave-

yard for bad loans and it played the key role at the turn of the century during the recapitalization of Czech banks before they were sold to foreign investors.

The KoB incorporated five institutions in 1999–2000—the Revitalization Agency (founded for several hugely complex cases—such as Aliachem, ČKD Praha, or Škoda Plzeň); the Czech Financial (Česká finanční) (purchasing of classified loans from small banks); Konpo (manages and recovers loans assumed from commercial banks); Prisko (took over all liabilities from the former state enterprise Škoda Auto, that is the debts before the company was taken over by Volkswagen) and Sanakom (for bad IPB loans from the ČSOB) (Teplá 2003).

The KoB had to operate in the same regime as the other banks—it had to follow the strict requirements for the creation of reserves and valuation reserves and it had to abide by various limitations—it was not allowed to acquire majority shares in nonbanking subjects, which greatly limited its chance to restructure enterprises it controlled (Teplá 2003). This is why the KoB ended its activity at the end of August 2001 and in September 2001 it was transformed into the Czech Consolidation Agency, which assumed its liabilities and became its legal successor. The agency was legally not a bank, but a special legal entity, which was not a subject to regulations like standard banks. Its main activity was the management of long-term liabilities for the state—restructuring enterprises, selling bad loans from its portfolio, and so on. The agency was closed at the end of 2007 and its legal successor became the Ministry of Finance.

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8.2.3 Dispute about banking loans

The number of banks on the market increased, but the impact on the provided credits was questionable. During the transformation, disputes about the amount of granted loans took the center stage on more than one occasion. The banking sector was also attacked for wasteful and insufficient lending. On the one side was the enterprise sector that demanded more loans and lower interest rates, and the government that hoped to keep the enterprise sector running through more loans. On the other side were the economists who claimed there were too many loans and the economy could not efficiently absorb them.

What were the opinions concerning the policy of banks at the beginning of transformation? Pick complained of restrictions and cautious lending by commercial banks (Pick 2000). Holman wrote that at this time the enterprises stopped getting loans automatically, which led to a situation where chances

to get a loan were limited (Holman 2000). Others claimed that the banks were too unwilling to lend and the growth of credit was thus lower than expected (Klaus 1991; Weighl 1992).⁵ Klaus wrote that commercial banks behaved rationally and were lending very carefully, which he did not quite agree with: “the center—the government and the central bank—cannot and does not want to give orders to commercial banks, although opinions of the government and of the commercial banks about credibility of a certain enterprise may differ” (Klaus 1991).⁶ Still others claimed that in 1991 the volume of loans awarded to the private sector grew rapidly—in 1990, the amount of loans was almost at zero and at the end of 1991 it amounted to 71.4 billion CSK (Dyba and Švejnar 1997). Hoen wrote that at the beginning of transformation, the Czechoslovak, and later Czech, economy avoided the freezing of lending that happened in Poland and Hungary (Hoen 1998). By contrast, Myant stated that if banks were more careful at this time, it would take the economy longer to get out of the transformation recession and it would probably grow slower in the mid-1990s, but it might have avoided the recession at its end (Myant 2003).

Once the first restrictive period faded, critical voices started to claim that banks lend fairly, but only to major state-owned clients. For example, Švarcová wrote that at the beginning of transformation, most companies were unable to get a loan (Švarcová 2000). Weigl observes that unhealthy relations between overextended enterprises—under the conditions of necessary conservative monetary policy—pushed many promising and beginning entrepreneurs from the credit market (Weigl 1992). Privatization was taking place at the same time. It was supported by loans, unless it was in the voucher form; besides, privatized enterprises needed capital if they wanted to restructure.⁷ Many authors believe that the economy in the mid-1990s was “overloaned” (e.g., Czesaný 2005).⁸ Sommer and Tůma write about a quick loan emission in 1994–96 (Sommer and Tůma 1999). Čermák believes that the banks were ready to finance almost anything during this period and provided absurdly high loans (Čermák 2000). Havel says that the first phase of transformation witnessed the credit expansion which was used to finance the origination of the Czech private sector and to keep contemporary enterprises alive (Havel 2004). Some authors wrote in this context about the soft banking environment, often referred to as “banking socialism” (e.g., Mlčoch 2000). The credit for private sector grew, but this banking policy was not cautious enough (Sojka 2000). Conversely, the CNB vice governor

Kysilka said in a 1995 interview that there was criticism of the lack of long-term loans in the economy. Kysilka argued that in advanced economies, such resources are provided by capital markets. But most authors believe that there were too many loans in the economy in the mid-1990s (see Table 8.5). The criticism is certainly not self-serving—the critics want to point to the roots of the ensuing problems in the banking sector—especially the growth in the volume of classified loans. On the one hand, this was caused by the high volume of free resources in the economy, especially due to the inflow of foreign capital. Additionally, analysts often point to explicit and implicit support of the government (e.g., Myant 2003).

Bankers and reformers defend themselves by arguing that in that period, there was no other option but to lend. Češka for example writes that it is a pure myth that it was possible to close the financial taps of the banks at the beginning of privatization; he claims only analysts who know nothing about the real situation of banks and enterprises say so (Češka 2003). Janáček writes that the number of registered companies increased between 1990 and 1993 from 19,000 to 1,100,000 and that there was corresponding growth in demand for banks services (Janáček 2009). This led to a decline in deliberation of providing of credits. Salzmann, a long-term CEO of the Komerční Banka, argues that the behavior of the banks was fully rational:

A loan was (before transformation) a prevailing, life-saving, legal and planned financial resource for state enterprises and cooperatives. This is why it was not secured in any way—with the loans, the bank (i.e., the KB) did not inherit any securities . . . Was there a real chance to require immediate returning in the situation where loans were not secured, enterprises had no money and the bankruptcy law practically did not exist? It would mean immediate and irrecoverable loss of all loans. The bank therefore decided to wait before the transformation of economy and privatization create better chances for new prosperity. This is why the loans for enterprises were renewed . . . It was a pure survival instinct: the hope of getting back at least something later was a better option than the certainty of getting nothing now. (cited in CNB 2003)

I find Havel's description fitting:

The planned economy mechanism was still used, i.e. any shortage of budgetary resources was replaced by the expansion of commercial loans—easy to

criticize, but it does not say what would happen if the banks introduced standard security rules immediately after the launching of the reform. A major part of the Czech economy could have come to a standstill, causing a chain reaction among other enterprises. We may therefore speculate about a certain transition phase, when the banks had to passively finance the economy. Another fruitless discussion could be to try to define the length of this phase, but we would probably agree that the phase was longer that it should or could have been. In general, the transformation problems were transferred to the banking sector and the banking sector did not signal their presence, but rather passively accepted it for several years. (Havel 2004)

Unfortunately, there are limited data about the development of credit at the beginning of the 1990s but we can see some of them in Table 8.5. The table shows a sharp drop (30 percent) in credits provided between 1990 and 1991 and only a relatively slow growth of credits in the mid-1990s. These numbers do not offer evidence of undisciplined behavior of commercial banks.

8.3 Crisis in the banking sector

The discussion above indicates that the Czech banking sector faced a crisis in the mid-1990s. The crisis affected both small and large banks, as well as credit unions.

At the beginning of the transformation, hunger for loans was immense and there were fears of oligopoly situation on the Czechoslovak banking market. For this reason, the banking licenses were issued quite benevolently and the situation lasted until the first banking crisis in 1993. In the first phase of the transformation, only small Czech-owned banks were involved in the crisis. The very first financial institution that faced problems was the Kreditní a průmyslová banka. Classified loans in the bank amounted to an enormous 90 percent and 450 million dollars disappeared from the bank (Mervart 1998; Stroehlein et al. 1999). The situation resulted from illegal over-the-limit loans for the companies of the general director, who also owned the bank. Forced administration was imposed on the bank and its license was taken away. Also in 1993, other banks got into trouble—AB banka, Kreditní banka, and Česká banka. The biggest debtors to these banks were their own shareholders who did not pay their loans. Another bank that went bankrupt was Banka

Bohemia, whose management signed guarantee certificates for dollar amounts in the total volume that was thirty times greater than the basic equity of the bank, which of course was illegal (Mervart 1998). In reaction to the problems of small banks, the CNB announced the banking sector consolidation program in 1994 (Consolidation program II). The central bank also ended its issuance of new licenses and tightened the banking supervision.⁹ Nevertheless, more small banks got into trouble. In 1996, the largest Czech private bank and the fifth largest bank on the market, suffered a loss—Agrobanka—which was a mid-size bank in Czech relations.¹⁰ In mid-2000, only four independent Czech banks survived on the market (in addition to large, partly state-owned banks)—Expandia, Plzeňská banka, První městská banka, and Union banka (Polouček 2000). Eventually, nearly all of them disappeared from the market (see Table 8.3).

Table 8.3: Number of banks in the Czech Republic (at the end of the year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Banks total	9	24	37	52	55	54	53	50	45	42	40
Large banks	5	6	6	6	6	6	5	5	5	5	4
Small banks	4	14	19	22	21	18	12	9	8	5	4
Foreign banks	—	4	8	11	12	12	13	14	13	13	12
Subsidiaries of foreign banks	—	—	3	7	8	10	9	9	9	10	10
Specialized banks	—	—	1	5	7	8	9	9	9	9	9
Under forced administration	—	—	—	1	1	0	5	4	0	0	1
Without license	—	—	—	—	1	4	6	10	18	21	23

Source: Havel (2001).

Expenses paid for the losses made by small banks were substantial, but still relatively small compared to the situation when large banks needed to be stabilized. The volume of classified loans was growing steadily. Between 1993 and 1994, the share of bad loans increased from 21 percent to 38 percent (Mervart 1998).¹¹ In 1994, 40 percent of loans went to loss-making enterprises (Myant 2003). Table 8.4 reveals the development of this index in the ensuing years; it is evident from the table that the volume of classified loans remained high throughout the 1990s.

Table 8.4: Nonperforming loans (in % of total loans)

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
40.4	30.6	30.2	31.5	37.8	33.8	14.5	9.4	5.0	4.1

Source: EBRD (2008).

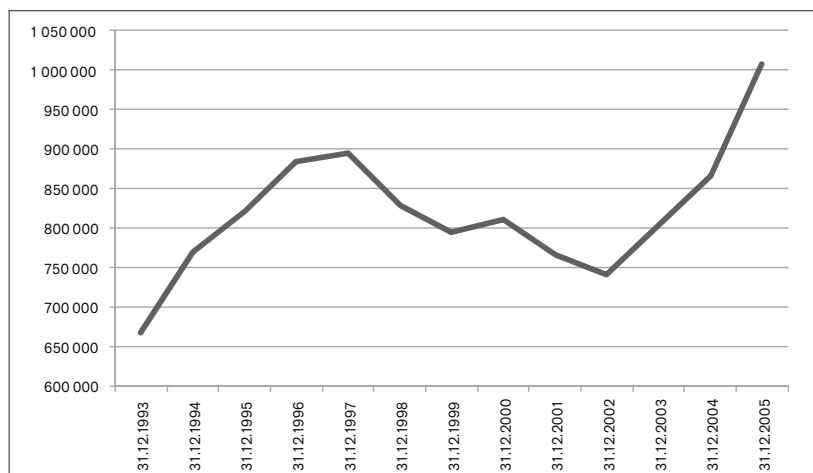
The banks were also influenced by stricter conditions, economic recession, and monetary policy. The previous trends resulted in credit crunch (see BOX 52), which hit the Czech banking market after 1997. This was the era of disputes about the importance of individual factors.

BOX 52 Credit crunch

During the post-1997 economic crisis period, the “credit crunch” was a widely discussed term. Opinions about the nature of this phenomenon vary, but in general it is a situation in which the banking sector has free resources, but the banks do not lend money, no matter what. Kubíček writes that the volume of awarded loans drops although interest rates do not change, while Singer defines credit crunch as a situation when “the interest does not clean market loans, and thus does not perform one of its functions, namely setting the price for the loan” (Singer 1999; see also Kubíček 2002).

The overall loans to non-bank sector declined substantially after 1997, as is shown in Figure 8.1. The volume of loans was declining de facto until 2002.

Figure 8.1: Credits to nonbank sector (millions of CZK)



Source: ČNB (2011).

The impact was widespread and all sectors were affected by this decline in credit as is shown in Table 8.5.

Table 8.5: Banking loans in the entire banking sector, 1989–2000
(in CSK/CZK and foreign currencies)

	All sectors	Industry	Construction	Agriculture	Trade
In CZK					
1989	991	570	90	79	124
1990	959	524	78	83	138
1991	678	312	55	49	97
1992	716	266	46	34	164
1993	762	259	48 (26)	31	173
1994	835	286	29	29	213
1995	826	284	29	32	214
1996	855	308	29	33	207
1997	841	274	28	29	191
1998	786	230	26	23	162
1999	747	221	22	22	142
2000	710	194	15	18	120
In foreign currencies					
1997	198	102	3	2	40
1998	221	100	2	2	34
1999	215	79	2	1	31
2000	186	49	1	1	23

All values were converted into 1995 prices using the prices of industrial manufacturers.

There is a gap in the time series in 1993

(number in parentheses is compatible with the previous).

Source: Myant (2003).

Opinions about the credit crunch differ. Holman believes that the credit crunch originated as a result of the dependence of the economy on loans, in the situation when high interest rates survived in the period of economic recession (Holman 2000). Enterprises ran into losses, loans turned bad and under such circumstances, the central bank tightened requirements for careful business—that is made the conditions for the functioning of banks stricter. Similarly Klaus writes that the slow decreasing of interest rates led to the growth of real interest rates which, together with additional restrictions on the commercial banks, led to the credit crunch (Klaus 2000). Pundits from the central bank think otherwise. Dědek maintains that the credit crunch was a reaction to the previous loan expansion (Dědek 2000).¹² Others claim that banks stopped

giving loans because they had doubts about the repayments, and not because of the monetary policy (*HN 2002 Yearbook* 2002). Jílek and Jílková agree, adding that the credit crunch was caused by the requirement of the central bank for higher capital adequacy, but they believe the development was substantiated, because there were too many loans in the Czech banking sector (Jílek and Jílková 1999). Finally, Havel writes that the stricter regulation, introduced by the CNB, made the hidden debts more open, while the privatization made the process more dynamic and the lack of loans even more painful (Havel 2004). However, the process was logical and necessary. Other factors might have played a role as well; for example, the lack of good business plans (*HN 2000 Yearbook* 2000).

Kubiček has a unique opinion, arguing that during recession years the overall amount of loans declined but the volume of newly awarded midterm and long-term loans did not decrease (Kubiček 2002). He argues that due to it, there was no credit crunch, but only a change in the structure of awarded loans (see Table 8.6).¹³

Table 8.6: Volume of newly awarded mid- and long-term loans (in CZK)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Newly awarded loans (in billions of CZK)	108.1	134.6	155.2	155.5	153.1	190	215.3	226.1	226.2
Growth (in %)	n.a.	24.5	15.3	0.2	-1.5	24.1	13.3	5	0

Source: Kubiček (2002).

Semi-state-owned banks were considered too large to go bankrupt and the state had to help them. Banks were cleaned especially in the preprivatization period. At the turn of the century, the crisis came to the credit union sector. The credit unions became fairly popular and in mid-1999, with 110,000 members and deposits exceeding 10.3 billion crowns (*HN 2000 Yearbook* 2000). The main attraction for the bank customers were interest rates that were significantly higher than those offered by ordinary banks. Since October 1999, credit unions started to face problems and forced administration was imposed on the three largest ones: Družstevní záložna, Rodinná záložna, and Českomoravská družstevní záložna. These three credit unions covered 60 percent of all credit union deposits. Problems in the sector kept piling up and in the following year, losses in the billions were uncovered and forced

administration was imposed on another twelve credit unions (*HN 2001 Yearbook* 2001). In 2000, as a reaction to these problems, the parliament passed an amendment to the act about credit unions, which limited room for deposit transfers into daughter companies, entered the branch, tightened operational rules, and increased the powers of supervision.

This growth of classified loans was the result of interplay of various factors. Some were specific for small or large banks, other were characteristic for the entire banking sector. One source of problems was lurking already at the beginning of the decade. Many state enterprises had debts they were not able to repay. Old debts from the era of planned economy often turned out to be irrecoverable. The banking sector was burdened with irrecoverable debts from the previous regime amounting to 190 billion (Angelis 1994). Weigl writes about high volume of bad loans from the past, which burdened enterprises and the banking sector (Weigl 1992). Thus the banks became vulnerable to expected failures of large debtors. Conversely, the government partly helped the banks to recover these loans by creating the Consolidation Bank. Regardless, later in the transformation, enterprises lacking capital usually turned to banks, because the capital market as the source of additional capital did not work.

What were the reasons for the growing volume of bad loans during the transformation? First, I could say that in the 1990s practically nobody had any experience with the market economy. Submission and approval of business plans was problematic. Market players frequently had no history and if they did, it was doubtful how they would adapt to the new situation. Similarly, the CNB authors (2003) write about the difficulties in understanding the business plans of the newly established companies. But ignorance was also on the side of bank loan officers.¹⁴ The management of banks, used to the centrally planned economy, was no different, adapting to the new situation with difficulties. Mervart openly writes about the failure of the banking management during transformation (Mervart 1998). Information asymmetry, a phenomenon of the functioning of the markets, played a major role in banks. Its result was a situation when the most active loan seekers are the ones with the most risky projects (Jonáš 1998a). The banks' problems also stemmed from the nonstandard economic environment (including macro-economic instability) and ownership relations. The supervision of bank owners on the functioning of banks was problematic. Especially in small banks, cheap loans were frequently preferably granted to the bank sharehold-

ers. In large state banks, the owner, that is the state (the FNM), practically did not intervene in day-to-day functions (Myant 2003). Some, however, point to political interventions (e.g., Havel 2001; Konkolská and Mielcová 2001), consisting mainly in explicit (but more likely implicit) pressure on the banks to lend and thus help the privatization process and the entire transformation. This situation, when the large banks were owned by the state for a long time, created moral hazard, that is the expectation that the state is in essence the guarantor of deposits (Jonáš 1998a). According to some authors, the linkage between banks and enterprises through investment privatization funds played a negative role as well (Simonson 2000, Urban 2005).

Last, I should mention the general institutional environment. Its weakness manifested itself for example in the bankruptcy law, which was too favorable to the debtor (see Chapter 11) and in weakly enforceable collaterals. It was thus difficult for the creditors to enforce their rights. The banks reacted by providing further loans, hoping that the debtors would eventually pay (for example, Čermák 2000). Havel (2004) wrote that the bank may turn down new clients, but the current client is in the same boat as the bank—Czech banks had numerous problematic clients that could not just have been “thrown overboard.” However, continued lending to companies were not successful under the new conditions (CNB 2003). Other institutional problems were linked with the banking supervision, which was not ready for the new reality and its weakness was apparent throughout the entire decade (Myant 2003).

I should also say a few words about the small banks, which were even less experienced than the larger ones. These banks suffered from deep shortage of their own capital and therefore carried out risky operations (Matoušek and Taci 2002; Weigl 1992; Weill 2003). The lack of capital was the result of weak confidence of depositors, which limited the banks’ ability to acquire more resources and diversify their assets. There were numerous criminal acts in this subsector. The situation in credit unions was similar, where the lack of experience, high interest rates, criminal acts, and shaky legislation were all taking place.

The points made here can be understood as a commemoration of problems that the banking sector had to face during transformation. The complex analysis of the banking crisis is shown in Diagram II at the end of the book. The total expenses on its stabilization are immense, but to a certain extent unavoidable.

8.4 Healing of the banking sector

As a reaction to the negative development of the banking sector, the government stepped in to help. It first decided to provide financial subventions to clean the banks from classified debts, followed by privatization of the whole banking sector at the turn of the century.

8.4.1 Government help

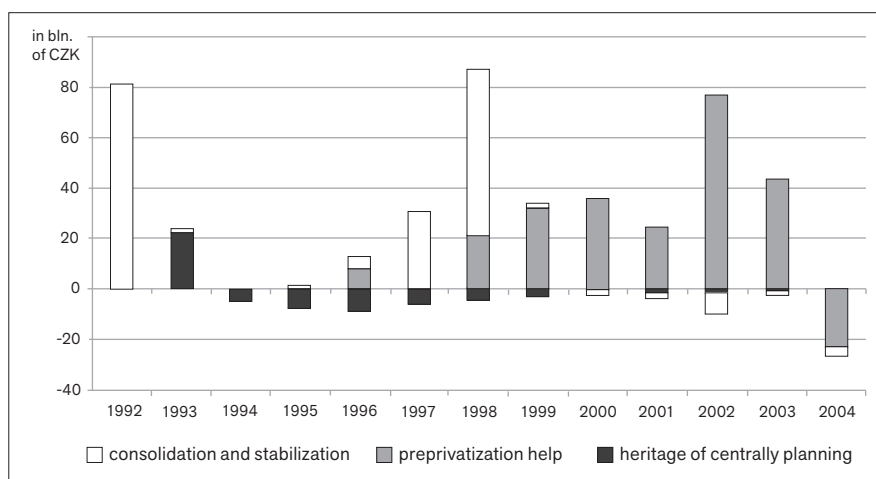
How was the banking sector stabilized? The state was trying to cope with the problems in banks for the entire decade. In 1991, the volume of classified loans in Czechoslovakia was estimated at 15–20 percent (Calvo and Kumar 1995). It was this year that the Consolidation program I was approved. Its purpose was to clear the current bank portfolios of problematic loans left behind by Czech and foreign subjects. These bad loans were taken over by the public sector, namely the Consolidation Bank. The Central Bank estimates the expenses of this program at 100 billion crowns, corresponding to approximately 10 percent of all bank loans (CNB 2003).

When the small banks ran into problems by the middle of the decade, the CNB reacted by announcing the Consolidation program II. It was designed for banks whose capital adequacy dropped below the minimum limit (8 percent). The gross amount of paid expenses amounted to approximately 33 billion CZK and the banks in the program eventually had their licenses taken away (CNB 2003). Another stabilization of the banking sector was linked to license withdrawals from the credit unions. Estimated losses in this sector amounted to 9 billion crowns (*HN 2001 Yearbook* 2001). The stabilization process was related mainly to the privatization of large banks.¹⁵ All banks, except for the ČSOB, had to be stabilized before they were sold, and the expenses were paid by taxpayers.

We can see the expenses on the banking crisis in two different forms: direct—that is the money of taxpayers, and indirect—related to the loss of confidence in the volume of savings. Over time, long-term expenses can be higher than the short-term ones (Jonáš 1998a). It is extremely difficult to estimate indirect expenses, because even the estimation of direct expenses is a tough task. The estimates of total expenses for the stabilization of the banking sector differ greatly. For example, Konkolská and Mielcová maintain

that the state paid 216 billion for the stabilization of four large banks, while the sale price was 112 billion, so the loss was slightly over 100 billion crowns (Konkolská and Mielcová 2001). Another source estimates the bank stabilization expenses at 330 billion, which was 17–18 percent of GDP for 1999 (*HN 2001 Yearbook* 2001). This ratio greatly exceeded the situation in Hungary for example, where the expenses on the stabilization of banks allegedly amounted to approximately 10 percent of GDP. Myant quotes the total expenses of 300 billion (15 percent of GDP; see Myant 2003). Žižka's more recent estimate presents the bank restructuring total expenses at 500 billion crowns (Žižka 2003). Havel is more optimistic, saying that the revenues from privatization amounted to approximately 100 billion and the expenses were three to four times higher (Havel 2004). However, Tuček protests, saying that 400–600 billion crowns disappeared; this money, he claims, is just the transformation expense. He writes: “it is often forgotten that the balance of state enterprises were unreal, their capital overvalued and most of them lacked operational capital” (Tuček 2000).

Figure 8.2: Estimation of restructuring costs in the banking system in CR, 1992–2004 (billions of crowns)



Source: Singer (2009).

Regardless of the direct costs of the financial restructuring of the banking sector, financial recapitalization is only a part of the complex consolidation problem. Szapáry sees three conditions for the stabilization of the banking

sector—macroeconomic stability; restructuring of the corporate sector, and a reform of the regulatory framework (Szapáry 2001). If we examine the Czech banking sector at the end of the 1990s, we find out that none of these conditions were met. The economy recorded the current account imbalance and currency crisis. Consequently, the whole economy fell into recession that was partly caused by troubles in the corporate sectors, with the regulatory framework criticized as well. During the following years the situation improved in all of these aspects and the banking sector became functioning well. The main reason was privatization of large banks that took place at the turn of the century (see Figure 8.2).

8.4.2 Privatization of banks

Let us note that at the beginning of 1990, there were four fully state-owned commercial banks in the Czech part of the federal state—Česká státní spořitelna, Živnostenská Banka, Komerční Banka, and Investiční banka, plus the Československá obchodní banka, in which the state held the decisive share. Some of the authors state that the highest privatization revenues could have been achieved in 1992–95, when the position of foreign banks on the Czech market was still weak, and the banks were not yet burdened with classified loans from the transformation process (e.g., Havel 2001).

In the era when new banks were being founded and foreign banks were entering the scene, the ownership structure of state banks was changing. In 1992, Komerční banka, Živnostenská banka, and Česká státní spořitelna were changed into joint-stock companies and a part of their shares was offered in the voucher privatization.¹⁶ In the same year, the decisive share in the Živnostenská banka was sold to a German investor, BHF Bank.¹⁷ After the voucher privatization, the state became a minority owner in the KB, the ČS, and the IPB—its share was approximately 48–49 percent, which ensured technical majority.

In the ensuing period the privatization came to a halt, mainly due to disputes in the government—see BOX 53. Politicians were, for example, afraid that privatization could lead to higher unemployment and there were also disputes about the sale of banks to foreign hands (Weill 2003).¹⁸ The situation of the banks was further complicated by minority shareholders, who filed lawsuits against essential decisions, including the increasing of basic equity,

and poorly performing courts. This process halting was widely criticized (e.g., Konkolská and Mielcová 2001). The effort to revive the privatization process in the banking sector was expressed in the government “packages” in 1997, but these attitudes were not politically popular (Mervart 1998).

BOX 53 Disputes about the pace of privatization of the banking sector

.....
Slow privatization of the banking sector turned out to be one of the most controversial moments in the entire transformation. The core of the problem was not in the state ownership itself, but rather in the inherited credit channels and the ensuing classified loans, eventually paid for by the taxpayers.

In addition to political reasons, economic reasons also contributed to the slow privatization of large banks. Havel wrote about state banks as the oases of stability in the era of initial uncertainty (Havel 2001). Later, he claims, the state banks became an important tool in the hands of politicians.¹⁹ Politicians were afraid that after privatization, the banks might close their credit taps for the home enterprises that did not meet strict international criteria. Klaus writes:

We could not start with the bank privatization, which is so applauded these days. We tried to introduce competition into our banking—to open the “entry to the market.” ... Now we all know that they did not introduce any real competition, because they did not want to get tangled up in the running transformation—but the three-four quickly privatized domestic banks would have acted in exactly the same way.

Half-state banks made mistakes in their credit-providing probably mainly because they provided loans “easier” than private, well managed banks would. But there were concerns—and I believe substantiated—that private banks would behave in a “nontransformation” way and that in the transformation phase (with changing prices, opening markets, ownership changes) they would simply not give loans to anyone. That would be a rational “risk-aversion” strategy, practiced for example by Živnobanka for the whole period. I do not dare to imagine what the economy would look like as a whole in such case. I would like to point that no postcommunist country started the transformation by privatizing banks. (Klaus 2000a)

This view of the reasons for the delay in the bank privatization is shared by many other analysts (e.g., Myant 2003; Simonson 2000; Weill 2002). Holman writes that the privatization of banks was slow because the privatization system was set up that way (Holman 2000). If the financing ended abruptly, the enter-

prises would get into trouble immediately. Mass privatization thus required delayed privatization of banks. On the contrary, Kunert believes that quick privatization of banks at the beginning of the transformation process would have led to generally prudent behaving of banks and better absorption of shocks (Kunert 2009).

Regardless of these views, the postponing of privatization enabled politicians to put pressure on banks—explicit or implicit—to help the transformation with loans that they would not provide in “normal” circumstances. Banks thus kept alive enterprises that should have gone bankrupt and provided resources for loss-making projects. A high percentage of loans later became classified (see Table 8.4). Moreover, the postponing of privatization led to other negatives. Banks did not get new capital and management, which they needed badly. Simonson writes that the politicians understood the shortage of financial capital, but did not understand the need for managerial capital; they expected the Czech managers would obtain the necessary know-how on their own (Simonson 2000). Therefore the banks improved their services only slowly, hand in hand with the know-how for quality management of financial resources. The state ownership also fed the moral hazard, as the banks expected that the state would help them out if they get into trouble.

However, it remains unclear how strong the link between the state and the banks really was. Havel notes that since the voucher privatization the state was a minority shareholder in the KB, the IPB, and the ČS (Havel 2004). Although the state had the technical majority of 48–49 percent, the execution of ownership rights was subordinated to the needs of the banks. Therefore the state representatives had to assert the best policy for the bank, not for the government or the FNM. He concludes that the institutions were in reality controlled by the management.

I understand the concerns of the reformers, yet I believe that the governments hesitated with the privatization of the banks for too long. If they had managed to privatize the banks in the mid-1990s during the economic boom, the consequences for the enterprise sector would not be too hard and the expenses for taxpayers would be much lesser. I agree with one of the reformers, who perceives the decision not to privatize banks as probably “the worst single mistake of the cabinet” (Dlouhý 1999).

.....

In the spring of 1998, *Investiční a poštovní banka* was sold to Nomura Group. The sale was quick and relatively cheap (the price was 3 billion CZK and

Nomura promised to increase the bank capital by 6 billion CZK). The price was low namely because the performance of banks in this period was weak—the bank had 20 percent of classified loans (Simonson 2000). The sale brought immediate political indignation and some parties talked about cheap sale of state assets (Simonson 2000).²⁰ Juchelka notes that Nomura was not a strategic partner, but an investment bank, open about its intention to sell the IPB in the future (Juchelka 2001). The new owner did not even change the management. The goal of Nomura was, according to Simonson (2000), to acquire the portfolio of enterprises owned by the bank and its funds—for example breweries and glass manufacturing companies. During the following recession, the bank ran into serious economic problems. In reaction to these problems, the IPB suffered strong outflow of deposits in the second quarter of 2000—between late February and early June, it lost 34 billion CZK (*HN 2001 Yearbook* 2001)—and thus became practically insolvent. On June 16, 2000, forced administration was imposed on the bank and within three days it was sold to the previously privatized ČSOB. The European Commission comments that it might have been the only choice, but the situation should have been prevented by better supervision (European Commission 2000). The forced administration and the sale were immediately surrounded by numerous disputes and speculations; for example, the nationalization of banks under unclear circumstances (Weigl 2003). The truth is that the ČSOB took over the IPB with state guarantees, planned to cover the expected losses. The guarantees may amount to 160 billion crowns (Žižka 2003).

In mid-1998, the Social Democrats won the election promising not to give any more state budget money to the banking sector. In reality, the ministers panicked and began to search hastily for foreign owners for state banks, offering state guarantees (Weigl 2003). The government pledged in its program declaration to sell the state banks before the end of 2000. The quick sale of banks was criticized for being impetuous and in time of economic recession. For example, Havel writes about the tactical mistake in the timing of privatization, because the sale took place during a crisis, lack of confidence in the banking sector, and the sale was cumulated into a relatively short period (Havel 2001). On the contrary, the obligation became an important motivation factor. The lack of confidence in the Czech banking sector was manifest in the unwillingness of foreign partners to take over old liabilities. All investors urged the government to purge the banks of the liabilities from the past. There was also a problem with the privatization advisors' motivation. They

were interested in making the price as high as possible and consequently in making the bank as clean as possible (Havel 2004).²¹ Tošovský's government decided that the potential buyers had to own a banking license and have higher rating than the CR. Thus the banks could end up only in the hands of renowned subjects from advanced economies. Havel maintains that the Czech way was suggested at the beginning and that it was not easy to enforce the aforementioned conditions (Havel 2003).

In the summer of 1999, the ČSOB (65.69 percent of shares) was sold to the Dutch KBC bank for 40 billion crowns, which was the highest net revenue from the sale of a bank in the entire transformation. The bank was sold to the highest bidder—the price was relatively high, because the ČSOB was the healthiest bank on the Czech market (Simonson 2000).²² Havel openly maintains that in reality, all banks except for the ČSOB had negative value before the privatization (Havel 2001).

In February 2000 the Česká spořitelna was sold to the Erste Bank, the only bidder who came up with a binding offer. This factor caused problems during negotiations, but the government decided that the negatives in case of delay, related to further lending and concerns about stopping the entire privatization process, outweighed the sale. The Austrian bank eventually paid 19.3 billion crowns for 52 percent of shares, but the state had already paid 46 billion crowns for its stabilization (Konkolská and Mielcová 2001). Classified loans were transferred to the Consolidation Bank. The high losses were caused mainly by bad loans provided in the 1990s, poor guarantees and the losses suffered due to the collapse of the Russian market after 1998 (Simonson 2000). The European Commission assessed the sale of banks as transparent (European Commission 2000). However, for example Weigl doubts the transparency of the entire undertaking, because the bank was sold to a preselected bidder (Weigl 2003).

The privatization process of Komerční Banka was interrupted by the B.C.L. trading scandal, where the bank lost 8 billion crowns in a single business case.²³ By mid-2001 the last large bank in the country was sold to the Societe General for 40 billion crowns. The new owner acquired the right to sell bad loans in the value of up to 20 billion crowns to the state before the end of 2003. The total expenses for the stabilization of the bank are estimated at 75 billion crowns (Konkolská and Mielcová 2001). Nevertheless, the sale of Komerční Banka was the most successful privatization of a bank of this size in any transforming economy (Havel 2004).

The privatization led to a situation where in 2003 95 percent of assets in the banking sector were owned by foreign owners with dominant influence of banks from the EU—73 percent (US banks made up 7.7 percent; Teplý 2003). Havel maintains that the banking sector was eventually stabilized and that the sale prices—the ratio between the price and the value of net assets—are among the best achieved during the transformation process; however, the issue of high costs remains. For the total number of banks owned by domestic and foreign owners see Table 8.7.

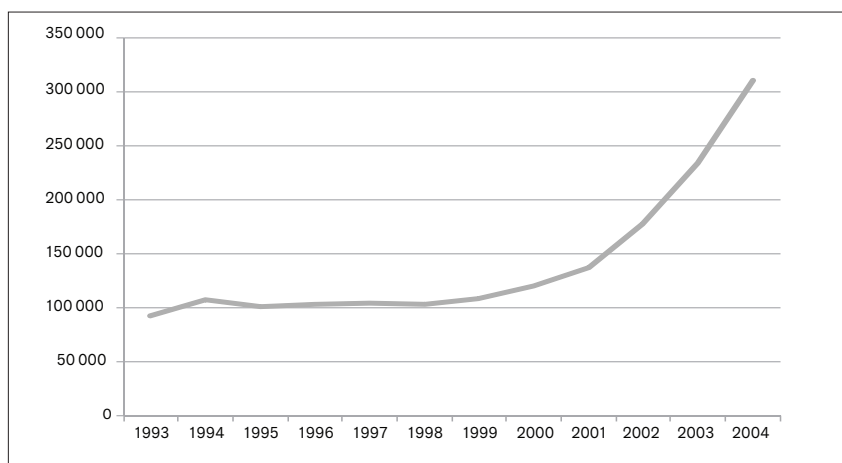
Table 8.7: Number of banks with decisive Czech and foreign involvement, 1990–2004

	Banks with a decisive Czech involvement	Banks with a decisive foreign involvement
January 1, 1990	5	0
December 31, 1990	9	0
December 31, 1991	20	4
December 31, 1992	26	11
December 31, 1993	34	18
December 31, 1994	34	21
December 31, 1995	32	23
December 31, 1996	30	23
December 31, 1997	26	24
December 31, 1998	20	25
December 31, 1999	15	27
December 31, 2000	14	26
December 31, 2001	12	26
December 31, 2002	11	26
December 31, 2003	9	26
December 31, 2004	9	26

Source: ČNB (2005).

At the end of the transformation period, the banking sector was stabilized. The price paid for this stabilization was high but banks finally started to behave as “standard” financial intermediates. Even if, obviously, the banking sector was still not functioning the same way as in the developed countries. Banks were providing credits without creating untenable amount of nonperforming loans. Figure 8.3 depicts the amount of loans provided to households, with a sharp increase after 2000.

Figure 8.3: Credits to households (millions of CZK)



Source: ČNB (2011).

There can be more objective measures of the state of the financial sector. An example can be international indexes that should evaluate and compare the overall functioning of the markets. One of them is the Capital Access Index by the Milken Institute. It provides “complex measurements, showing that efficient financial markets make capital accessible to the entrepreneurs who can use it to grow.” Table 8.8 shows that the Czech Republic was on the fully comparable level with the other postcommunist countries.

Table 8.8: The Capital Access Index, 2004

Rank		CAI
1	Hong Kong, China	8
2	Singapore	7.99
3	United Kingdom	7.92
6	United States	7.76
17	France	6.62
20	Estonia	6.57
31	Hungary	5.59
34	Czech Republic	5.46
44	Slovak Republic	4.99
49	Russia	4.71

Maximum possible score is 10.

Source: Barth et al. (2005).

8.5 Stock exchange

In addition to banks, capital markets make up another cornerstone of market economies.²⁴ These markets did not exist in the socialist economy. In the following subchapter, I will shortly discuss the new genesis and subsequent development of the capital markets in Czechoslovakia and then in the CR. Circumstances of the emerging Czech stock exchange are related to the voucher privatization. Nevertheless, already in January 1990, the first emission of Komerční Banka bonds appeared on the market, in the amount of one billion crowns, which was sold on the primary market (Pudlák and Neset 2005). In October 1990, the Ministry of Finances emitted state obligations to finance the recovery of property rights. Since mid-1991, the SBČS started to organize a temporary securities market with auctions arranged every two weeks, where only obligations were traded. At the end of 1992, the temporary market was taken over by the newly established Prague Stock Exchange (BCPP).²⁵ Official trading began in April of the next year. In June 1993, 622 share titles from the first wave of voucher privatization were introduced, and a month later, another 333 emissions were added. 8.5 million Czechoslovak citizens became shareholders. Since March 1993, the obligation market offered the first regular obligation and enterprises followed suit soon (for example, the ČEZ and large banks). In September 1994, everyday business on the stock exchanged was launched. The emerging capital market as a result of the voucher privatization was often criticized (for example, by Pudlák and Neset 2005). However, others maintain that the problem was not in the voucher privatization proper, but in the inadequate rules and high expectations that such market could not meet, which was not the fault of the voucher privatization (Hrubý and Rudlovčák 2002).

In the mid-1990s, there were over a thousand emissions on the market, and the number even grew early in 1995, when 674 titles from the second wave of the voucher privatization were introduced. The offer was further expanded with the shares of privatization funds. However, the market suffered from numerous faults. Interest in most shares was weak and most trading was in obligations. Besides, such trading was usually direct, concluded between two traders, that is de facto outside the stock exchange, where it was only registered ex post facto—the business was not part of the cumulative offer and it had no influence on the creation of prices (Pudlák and Neset, 2005). The authors claim that the direct trading constituted up to 90

percent of all share trading; and de facto 100 percent of obligations at that time.

Institutional setting of the entire capital market—especially the protection of minority shareholders—was a widely discussed topic. Investors, once they achieved majority, could easily use their position and for example withdraw a title from trading—the chances of small shareholders to sell their shares were thus limited. This fact was often criticized (e.g., Dobešová et al. 2003; Sommer and Tůma 1999; Tošovský 2000). It might have contributed to the subsequent drop and stagnation in the stock exchange index (PX-50; see Figure 8.4).

Figure 8.4: Prague Stock Exchange PX-50 index, 1993–2005



Source: Prague Stock Exchange (2005).

However, Havel cites numerous other root causes that were discussed at the time—it could have been natural development in the given market phase; impact of unfavorable situation in the emerging markets, suffering from poor confidence after the Mexican crisis; or a consequence of the overall non-standard institutional setting of the Czech markets (Havel 1995). Havel opines that the main reason was high supply and low demand—that the market offered too many titles, both shares and obligations. Dillon and Wykoff offer another perspective—they observe that after 1996, numerous foreign invest-

ments left the Czech stock exchange due to weak regulation, widespread embezzlements, and the lack of interesting investment opportunities (Dillon and Wykoff 2002). Pudlák and Neset, for example, complain that it took too long for the Czech legal environment to do something about the embezzlement (Pudlák and Neset 2005). Weak legislative setting of the capital market rules is also mentioned by other economists (Frait and Kotlán 2000; Kořená and Kořený 2001). Poor regulation of the capital market is discussed by Tošovský (2000; see also Urban 2001). Mlčoch adduced numerous reasons why the Czech capital markets did not work—missing information about the companies, lack of qualified analysts, nonexistence of anti-insider-trading legislation, lack of transparency in the behavior of the market coordinator (Mlčoch 2000). Fawn perceived the capital market as a major Czech problem (Fawn 2000).

Hrubý and Rudlovčák write that the nonstandard character of the capital market was widely criticized, as well as the fact that it was not regulated like in the western countries (Hrubý and Rudlovčák 2002). They saw the principal problem in a fact that most enterprises, which constituted the core of the capital market, should not belong to a standard market. They also opposed the excessive protection of minority shareholders, which made it hard to acquire a majority share in an enterprise, a basic condition for any meaningful restructuring. Similarly, Loužek opined that the regulation of markets was weak, but that the government did not underestimate the legal frame (Loužek 2001). He believes that the immaturity of the Czech markets was a good reason for weaker, not stronger regulation, because investors are willing to provide their money if they anticipate that higher risks will bring higher revenues. Regulation caused the outflow of foreign capital and lowered the liquidity of the Czech market. Holman claims that Czech capital markets were conceived as ownership rights markets, rather than standard capital markets. He also says that the transformation to a standard market would slow down the process of ownership change (Holman 2000).

Such views show broad attitudes toward the functioning of the stock exchange in the transformation process. We can generally distinguish two main attitudes—one group of authors wanted to create a standard institution that would work similarly to the western counterparts. The second group of authors wanted to use the new born stock exchange mostly for the privatization needs. The situation was even more complicated because of the two different global models of the functioning/importance of the capital markets—see BOX 54.

BOX 54 Continental vs. Anglo-Saxon model

In general, capital markets can operate in two basic ways. One model is continental (or German) and the other Anglo-Saxon. In the continental model, banks can be major shareholders in large enterprises, which they also finance (Tříška 2002). Thus the banks occupy a privileged position in the entire system (Mlčoch 2000a). Owners play a key role in the companies and maintain close relations with the management. The stock exchange is not as important as in the Anglo-Saxon model. Withdrawal from the market is very limited, and such practices as a hostile takeover practically do not exist. In the Anglo-Saxon model, ownership is more spread and the management plays the key role, being relatively independent. However, managers are under pressure to show good results, otherwise shareholders start selling their shares, the price drops and there is a pressure to replace the management with a more effective one. The stock exchange is an institution that enforces (through anonymous markets) management discipline.

Tříška further maintains that the continental model—due to the link between the enterprises and the banks—is less rigorous toward debtors, both in loan awarding and in debt recovering (Tříška 2002). Trade unions play an important role in the system, especially in the participation of employees in the management and existence of collective agreements. Loužek links the models with the liquidity of the markets (Loužek 2005). On more liquid markets (US and UK), atomized stock ownership is the price paid for the liquidity, resulting in the “strong managers—weak owners” model. In the Continental Europe, the decision-making process is in the hands of several shareholders, the market liquidity weakens and the control over the corporate management deepens. The model could be summed up “weak managers and strong holders of the controlling interest” (Loužek 2005).

Tříška also notes that one of the goals of the voucher privatization was to create a significant counterbalance against the Austrian-German system, which was expected to set roots in our country anyway” (Tříška 2002).²⁶ This is why the system used investment privatization funds, analogous to shares funds in the Anglo-Saxon model. Some describe the Czech market after the voucher privatization as a hybrid—something between the continental and the Anglo-Saxon model, probably because of the strong link between the banks and the enterprises (Mlčoch 2000a; Myant 2003). Moreover, the link was further strengthened by the role of the banks in the voucher privatization. The market was first liquid with spread ownership, but later the ownership

concentrated and the market liquidity dropped hand in hand with the power of management (Loužek 2005).

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Rules and conditions at the stock exchange were gradually being improved. In September 1995, quoted and nonquoted market transformed into the main, secondary, and free markets. KOBOS, the system of continuous trading with changing price was implemented, and replaced by even more effective SPAD (Share and Security Market Support) system in 1998, which continuously quotes the most liquid shares and in which over 95 percent of share trading is currently being realized (Pudlák and Neset 2005). In 1996, a more consistent protection of minority shareholders was introduced, and in 1998, the Securities Commission was singled out as an independent authority (the market was previously supervised by the Ministry of Finance) but the ensuing disputes largely paralyzed its activity.

At the beginning of the twenty-first century, fears about the stock exchange were gaining momentum—concrete owners for Česká spořitelna, Komerční banka, and České Radiokomunikace were found; the government tried to sell ČEZ, Český Telecom, and Unipetrol; rumors spread that Philip Morris shares would be withdrawn from the market; consequently, there was the danger that no important title would remain on the stock exchange (Skřivánek 2004). The Czech share market died out once the controlling interests were shifted—it turned out that in the small Czech economy, finding a specific owner or a small group of owners for each enterprise is not a problem (Sommer and Tůma 1999). Eventually, la Société Générale decided to leave its free stock on the market, Česká spořitelna stock was replaced by the Erste Bank and the remaining privatization attempts ended in fiascos (Skřivánek 2004). In 2002, the net Czech stock market expressed in the dollar achieved the highest growth in the world (The Foresight Saga Continued 4th of January 2003).

What was the long-term stock-exchange development? An important long-term trend was the decreasing number of quoted titles (see Table 8.9), primarily due to weak liquidity and subsequent non-fulfillment of stock exchange requirements. In 1997, 1,300 titles were withdrawn in four stages, and the trend continued in the years to come.²⁷ Many new majority owners also withdrew from the market once they achieved majority in the enterprises. No new share emissions were coming to the stock exchange—before the entry into the EU, not a single primary emission took place—and the Prague Stock

Exchange thus did not fulfill one of its key roles as a source of new capital for enterprises. Consequently, the number of stock titles was permanently decreasing. On the contrary, we may state that the number of obligations on the stock exchange since 1996 was more or less constant, oscillating between 80 and 95 emissions (Pudlák and Neset 2005).

Table 8.9: Development of the number of registered shares and share certificates on the Prague Stock Exchange, 1993–2005

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
971	1028	1716	1670	320	304	195	151	102	79	65	55

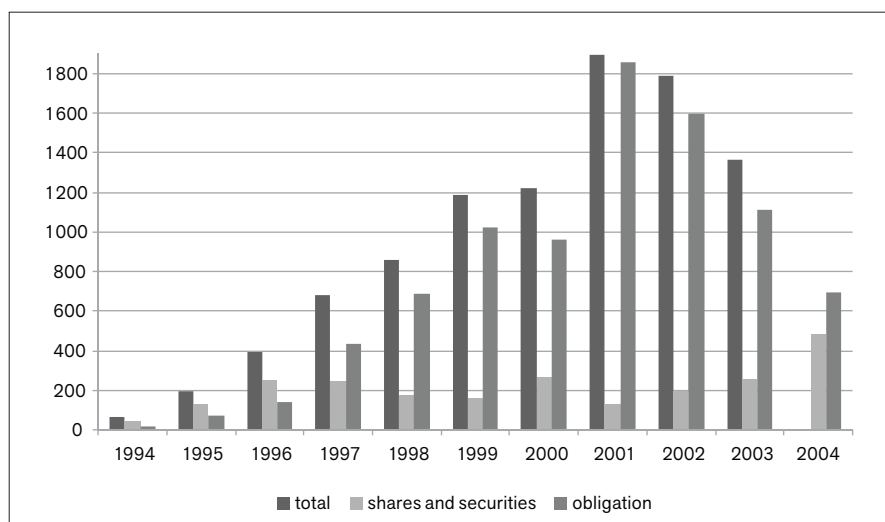
Source: Prague stock exchange (2005).

Pudlák and Neset declare that capital markets should in general fulfill informing functions—the market informs about the price of capital, value of investments, and about effective functioning of companies and entire branches; allocate function—the market makes it possible to move capital effectively and quickly; and the function of the financing source—emitters acquire new capital on the market (Pudlák and Neset 2005). It is obvious that the Czech stock market fulfilled its functions in transformation in only a limited way. Consequently, enterprises were able to acquire new capital essentially only in banks, which created a close relation between the enterprises and the banks (for example, Calvo and Kumar 1995; Hoen 1998). However, the obligation market works fairly well (Pudlák and Neset 2005; see also Figure 8.5).

The entire transformation process was closely linked with the development of the banking sector. Banks are key tools in transforming deposits to investments, and if this relation is damaged, the economy as a whole suffers. The Czech banking sector coped with the transformation with great troubles—amassed mistakes, but also ignorance and sometimes criminal acts brought about a crisis in the entire sector. The crisis hit both small and large banks. The former group gradually disappeared from the market, while the latter was stabilized using the taxpayers' money. The causes of the crisis differed. "It is difficult to categorize individual factors by importance—but it is not true that the ignorance or criminal activities of bank managements and shareholders are to blame for everything. On the contrary, most of it stemmed from the communist heritage and from the fact that the banks had to carry the cost burden of the transformation" (CNB 2003). Klaus claimed

that the banking sector could not have been much better, because the banks in the 1990s were undergoing a certain (necessary) phase of development (Klaus 2000). I should also add that the banking sector problems are not unusual even in the west. The stabilization efforts combined with substantial financial resources led in the end to a creation of a stable banking sector. But the costs were high.

Figure 8.5: Trade value development on the Prague Stock Exchange, including block trading, 1994–2004 (in billion CZK)



Source: Prague stock exchange (2011).

In my view, the transformation of the banking sector played a key role in the privatization process as such. The reformers had a choice about the speed of privatization. They could decide to privatize banks quickly—that would mean probably relatively low costs for the cleaning of the banks but the banks would not be willing to do risky operations—such as lending money for privatization purchases. Or they could decide to postpone privatization. It would mean that the banks were more supporting the transformation process but there would be probably costs in the form of risky transactions. They decided more or less for the second alternative. I cannot say what exactly the first alternative would have meant—how the Czech environment would look if the banks had not been willing to lend relatively easily since the beginning of the transformation process. Or see it from a different angle. Companies are in

the core of the transformation process—the reforms tried to create a mixture environment with sticks and carrots. Behaving of the banking sector was more carrot than stick and the relatively soft financial environment helped old as well as new companies. The question remains if this was the optimal mixture. I can understand political obstacles but privatization of the banks at least in the middle of the first transformation decade would have diminished the costs of transformation, and it would naturally restrain strong economic growth in the respective period. I generally deem postponing of privatization in the period as one of the main mistakes of the whole transformation process. Still, the banking sector obviously improved in the end and after high costs achieved the international level. Since the beginning of the twenty-first century it was able to provide companies as well as households with needed capital.

The stock exchange developments were also problematic. Unfortunately, the Czech stock exchange never became an alternative source of capital for enterprises and its importance during transformation lies rather in the fact that it enabled ownership concentration. But we should not be surprised by this development if we take into consideration that the stock exchange started from scratch and the Czech market is very small.

Notes

- ¹ Sommer and Tůma write that the CNB and the Ministry of Finances are jointly responsible for soft granting of licenses, which created competition, but was widely abused (Sommer and Tůma 1999). On the contrary, Vencovský wrote that the CNB should not be blamed for having granted too many licenses (Vencovský 1994). He believes the market tests the banks better—sometimes painfully for the clients—than the administration of the central bank ever could.
- ² In 2011, the state owns directly 80 percent of the Czech Export Bank and the rest is owned by EGAP.
- ³ Myant maintains that the bank was established in reaction to protests of employees and management in several large companies, and it was initially planned to operate for only 125 days (Myant 2003).
- ⁴ According to the later data, the companies paid most of this amount and the loss from the operation amounted to “only” 18.3 billion CZK (Páral 2005).
- ⁵ Banks were lending less than the loan ceilings (see Chapter 4). The CNB vice governor Jan Vít said in a 1992 interview that loans for privatization were not limited in any way, because these were highly risky operations and the banks would normally never lend any money. As there was no limit, the banks could lend money for individual projects up to the full volume of their resources (Štatavová 1992).
- ⁶ The government and the central bank tried to improve the situation by the liberal granting of bank licenses.
- ⁷ This issue was closely related to the privatization of the banking sector (see BOX 53).
- ⁸ See also Dědek (2000); Jílek and Jílková (1999); Urban (2001).
- ⁹ Other aspects of the institutional environment were changing as well, as time went by. For example, since the end of July 1994, the banks were obliged to insure non-anonymous crown deposits of physical persons below 125,000 CZK. If the bank went bankrupt, the depositors were entitled to up to 80 percent of their deposits. The amount later increased.
- ¹⁰ The total losses associated with Agrobanka amounted to 35 billion CZK (CNB 2003).
- ¹¹ The growth was partially caused by modified methodology (Jonáš 1998a). Unfortunately, I was not able to obtain homogenous statistics of nonperforming loans.
- ¹² Janáčková writes about the significant impact of the credit crunch on the economic policy. The monetary expansion efforts of the central bank in 1998–99 did not lead to economic boom due to this phenomenon and related paralyzing of the

most important transmission channel in the monetary policy (Janáčková 2000; see also Frait and Kotlán 2000).

- ¹³ Similarly Pospíšil wrote about slower growth of loans for the enterprise sector, but he did not perceive this phenomenon as the credit crunch, using his own analysis (Pospíšil 1999).
- ¹⁴ Most bank employees were trained in the traditional monobank system, in which such terms as the risk or profitability were either unimportant or secondary (Calvo and Kumar 1995).
- ¹⁵ Aid to the banks was an issue during accession negotiations with the EU. For example, Žižka maintains that the European Commission criticized it (Žižka 2003). The CR was reproached primarily for providing of bank warranties that could potentially influence the equality of conditions on the common market.
- ¹⁶ The voucher privatization did not involve only the ČSOB, owing to the complicated situation in the solving of former state liabilities, which were formally part of the bank balance (Havel 2004).
- ¹⁷ The BHF Bank acquired a 40 percent share. Another shareholder was the International Finance Corporation, a subsidiary of the World Bank, with 12 percent share. 46.56 percent of shares were sold in the voucher privatization and 1.44 percent went to the RIF.
- ¹⁸ The KDU-ČSL politicians opposed the privatization of Česká Spořitelna for fears that it might end up in German hands (Holman 2000).
- ¹⁹ Originally, privatization was supposed to take place within two to three years (Havel 2004).
- ²⁰ The state lost majority in the IPB in 1994, when it did not increase the basic capital, which was perceived as a major failure of the state. The fact was one of the reasons for the low price. The causes of this failure were not explained even by the parliamentary committee that investigated the bank fall in 2000 (Konkolská and Mielcová 2001).
- ²¹ On numerous other technical and tactical problems during privatization, see Havel (2004).
- ²² The ČSOB was rid of its liabilities from the previous regime in 1993 and subsequently did not receive any more state money or warranties (Konkolská and Mielcová 2001).
- ²³ Between June 1998 and July 1999, Komerční Banka lent the B.C.L. trading company 450 million dollars (Coufal 2000). The letters of credit were tied to the supplies of large amounts of Russian and Ukrainian agricultural products from the company Stone & Rolls to the B.C.L. Subsequent investigations found that the supplies never took place.

- ²⁴ For example, Calvo and Kumar believed that stock markets were so important that they should have been part of privatization and the entire transformation from the very beginning (Calvo and Kumar 1995).
- ²⁵ Ježek maintains that the Prague Stock Exchange was created as the exact copy of the Paris Stock Exchange (cited in Husák 1997).
- ²⁶ For example, he claims that the 1992 Business Code was fully in the Austrian-German tradition.
- ²⁷ Similar development as on the Prague Stock Exchange occurred in the RM-System.
- ²⁸ In the mid-1990s, a 20 million emission of Software602 company was realized in the RM-System. Then came two unsuccessful stock exchange emission attempts (Bonton, Interkontakt Group, and Limart), and another primary emission (Zentiva) did not take place before 2004 (Skřivánek 2004).

ENTERPRISES DURING TRANSFORMATION

For the development of the economy as a whole, the key factor is the development of the microsphere (i.e., enterprises). This chapter discusses the transformation's impact on enterprises and on selected widely discussed issues related to the enterprises in this era. It is obvious that the position of enterprises is directly linked to privatization, the banking sector and capital market developments.

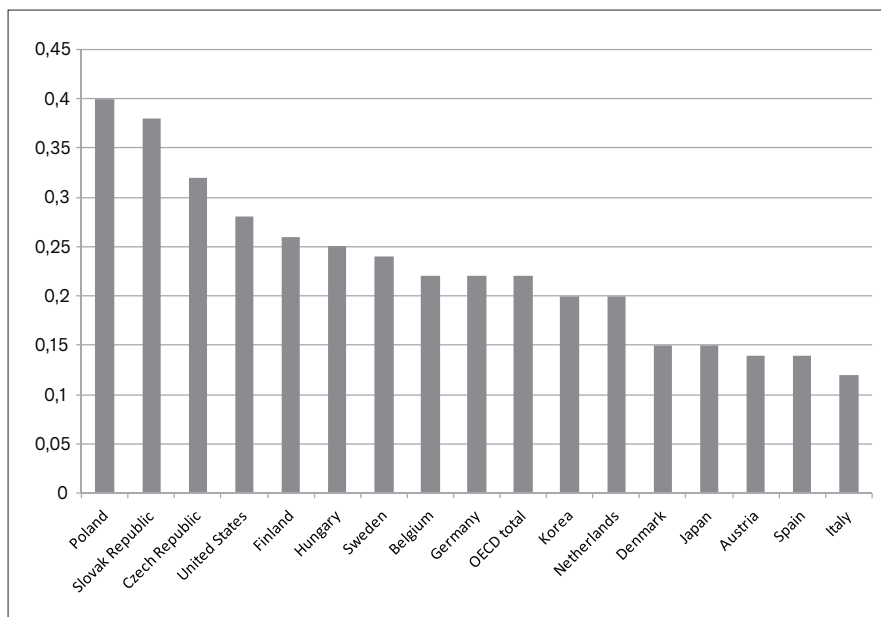
To begin, I will briefly review the situation at the end of the communist era and then I will focus on the impact of reforms on the enterprises, on the development of the sector including restructuring disputes and industrial policy. Next I analyze the overall development of the sectors during the transformation period and I sum up structural changes that took place.

9.1 Situation of enterprises at the beginning of the transformation

At the end of the 1980s, Czechoslovak enterprises suffered from numerous maladies (see Chapter 1). The enterprises were ineffective and wasted resources. Figure 9.1 demonstrates this situation by comparing the state of energy consumption at the end of the 1980s in the Czech Republic with other countries.

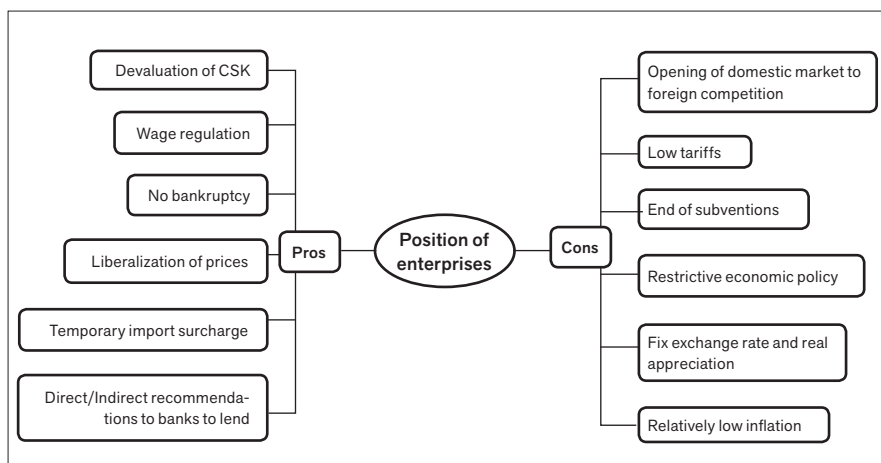
Consequently, enterprises could not compete on global markets and their production was oriented toward soft eastern markets. Enterprises were centrally controlled, with limited (if any) own initiative. As a result, the country was lagging behind in labor productivity.¹ The management of enterprises was linked with the ruling party and unprepared for market conditions. The previous negatives resulted, among other things, from weak motivation,

Figure 9.1: Tons of oil equivalent per 1,000 USD of GDP calculated using PPPs, 1989



Source: OECD (2010).

Figure 9.2: Pros and cons for the state of the enterprises during the transformation process



which ultimately led the companies to the effort for maximization of inputs and minimization of outputs. The entire economic structure was warped with the orientation of socialist economists to industry (especially heavy and military) and for monopolization. De Melo and colleagues estimated the level of overindustrialization in percent of GDP as a difference between actual and predicted (correspond to GDP) industrialization. The number for the Czech Republic in 1990 reached 21 percent and was one of the highest among the centrally planned economies (for example the same number for Poland was 13 percent and for Hungary -1 percent; De Melo et al. 2001). In addition, the enterprises were in debt and their general condition was critical. Tříška quotes a study according to which 80 percent of enterprises should have been technically bankrupt by that time (Tříška 2002).

9.2 Impact of reforms on the enterprises

Developments in the microsphere are essential for the success of the economy as a whole. What was the position of enterprises at the beginning of transformation? Was the impact of initial reforms too hard or too soft? Advocates of both opinions can be found among economists. The position of enterprises is one of the most disputed areas among them. After a closer look, it becomes clear that the position of enterprises was not black and white and that some reform measures made their position easier, while others made it more difficult.

Which factors made the situation of enterprises more complicated? Generally, among these factors there were changes that increased competition in the inner market. They were caused by domestic as well as foreign factors. The basic factor was the liberalization of foreign trade. Customs tariffs were lowered in 1991 to the average value of 5 percent and domestic enterprises were exposed to almost unlimited foreign competition. Some authors believe that the liberalization was too fast or too far-reaching (e.g., Sojka 2000).² Another pressure on the enterprises was the liberalization of business for new subjects, further increasing domestic competition. The initial reform strategy was based on monetary and fiscal restrictions. The monetary restriction manifested itself in difficult availability of loans, and fiscal restriction led to termination of subsidies for loss-making enterprises. All this took place in the situation of ownership lawlessness, when the state was unable to exert

its ownership rights. Enterprise managers were completely unprepared for the new situation. Enterprises obviously protested against the pressures they had to face as a consequence of reforms.³

By contrast, the government took numerous measures that alleviated the situation for the enterprises, including both transformation cushions (foremost huge devaluation), delayed bankruptcy law amendments and wage controls.⁴ The liberalization of foreign trade was temporarily accompanied by the import surcharge. The liberalization of prices led to the situation in which real interests were negative and the inflation partially erased corporate debts (Sojka 2000). In 1991 the government also created the Consolidation Bank, which took over a part of bad loans from the previous regime, thus alleviating the burden on enterprises. However, the government refused to implement a universal industrial policy (see BOX 55) and provide aid to companies.

BOX 55 Industrial policy

One of the controversial issues of the economic policy during transformation was the application of industrial policy.⁵ For most, it is related to state-implemented restructuring. Since the beginning of transformation, the government was against active industrial policy in principle—it perceived it as the continuation of the previous practice of subsidizing unsuccessful companies by the successful ones. There were several arguments against the industrial policy. Myant observes that there were substantiated fears that the state might support the enterprises that complained the most (Myant 2003). Sacks wrote that planning was unpopular after 1989, including any industrial policy for specific sectors (Sacks 1993). Borenzstein doubts the ability of the government to “choose winners,” because this was what the state bureaucrats did for the previous forty years, with pitiful results (Borenzstein 1995). Klaus sums up his opinions as follows: “the prosperity era of those who were able to use their acquaintances to exert political pressure to enforce redistribution of economic resources in their favor, was over” (Klaus 1994).⁶

However, critics claim that the state should have implemented an active industrial policy. This group includes Sojka, who writes that the government should have asserted “industrial policy compatible with the market” (Sojka 2000).⁷ Similarly Pick believes that the industrial policy should have been implemented “ex ante” (Pick 2000). Levčík also speaks in favor of the industrial policy (Levčík 1992). Mládek sees the problem in the nonexistence of implicit

or explicit industrial policy (Mládek cited in Janáček and Klvačová 1994). He saw the greatest danger in an ad-hoc industrial policy, which “practically means no industrial policy.” Critics claim that the industrial policy should be systematic and it should be known beforehand who and why the government intends to support (see, e.g., Janáček and Klvačová 1994). Janáček and Klvačová observe that the government does implement industrial policy from the very beginning of the transformation, but verbally they distance themselves and the rules of this policy are not clear. Pick writes:

Refusing microeconomic (especially industrial) policy created the danger—in spite of extreme lowering of wages and currency exchange rates—that instead of restructuring, a major part of industry would simply disappear. The strategy that first entirely refused any industrial policy supporting competitiveness of enterprises “ex ante” (supporting promising comparative advantages) with the textbook justification that such policy would determine the “winner” instead of the market (although it could mostly have been implemented in accordance with individual criteria and rules), created a growing sector of “losers” (loss-making and indebted) enterprises. This is why the cabinet later chose “the lesser evil” (than no industrial policy) and, instead of “ex ante” industrial policy, they (ironically) opted at least for a reversed quasi-industrial policy, directed “ex post facto”—to subsequent saving of the “losers” (endangered). Such an individual approach was not only less effective, but also much less transparent. (Pick 2000)

In reality, the government helped (see Table 9.1). But I must note that information about subventions varies substantially among the different sources.

Table 9.1: Budgetary subsidies and current transfers (% of GDP)

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
6.4	7.1	7.6	6.8	7.1	7.0	6.7	7.2	8.8	9.6	9.5	8.4

Note: subsidies to enterprises and financial institutions, including the Czech Consolidation Agency.

Source: EBRD (2008).

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Economic policy toward companies was certainly not simple. On the one hand, competitive pressure on the enterprises increased. On the other hand, companies were provided with temporary space to improve the quality of their production. If the government wanted, the conditions for enterprises could have been much tougher. The initial question should be: What goals

did the government follow on the enterprise level? The government economists were afraid of the abuse of the situation by monopolies, and this is why they thought it was necessary to expose the socialist juggernauts to competition. Another general goal was to orient the production toward what was in demand both at home and abroad—that is restructuring. How could such situation have been achieved without tough conditions for the enterprises? If the situation for companies was made easier, they would hardly restructure. Market subjects generally react to the impulses that they receive from the environment. The companies behaved in a rational way and tried to soften the conditions for themselves as much as possible and avoid any changes. They successfully tried to bend the conditions to their needs. They were not under the competition pressure as a result and thus did not try (and did not have to) to improve their production, increase their productivity, improve the quality of their production, and so on. At the same time, there was talk about improving the quality but the companies in reality did nothing or close to nothing. They were operating in this environment for forty years. It is naive to think that enterprises would have set off toward changes just because of a hypothetical future pressure. The presumption that they would not have made any progress, if there had not been a pressure on them, seems to be much more realistic. The companies would have expected that they would somehow “muddle through” as they have done before and would have indefinitely postponed any real changes. According to some economists, such situation happened anyway, because enterprises did not use the room provided by transformation cushions (Dillon and Wykoff 2002).

There is no doubt that the reform seriously hurt most enterprises, especially when domestic problems were combined with the disintegration of eastern markets. There are several examples from branches that used to be “show windows” of Czechoslovak industries. For example, shortly before the regime change the ČKD built new capacities for the manufacturing of trams of 1,800 vehicles per year (950 pieces were made in 1989), but the global sales in early 1990s amounted to only 2,000 pieces (Myant 2003). Disintegration of eastern markets and the overall economic decline caused total collapse of production that dropped to thirteen pieces in 1991.⁸ Or we can consider the development of the shoe industry. It used to be traditional Czech production during the First Republic, with Baťa being the most prominent example. Czechoslovakia remained a great shoe-making power in the period of the central planning. Seventy-three million pairs of shoes were made in the country in 1989, of

which three-quarters were sold on the domestic market (Myant 2003).⁹ In 1995, the volume of production fell to 25 million pairs, of which 80 percent was exported. The development in the shoe industry is shown in Table 9.2.

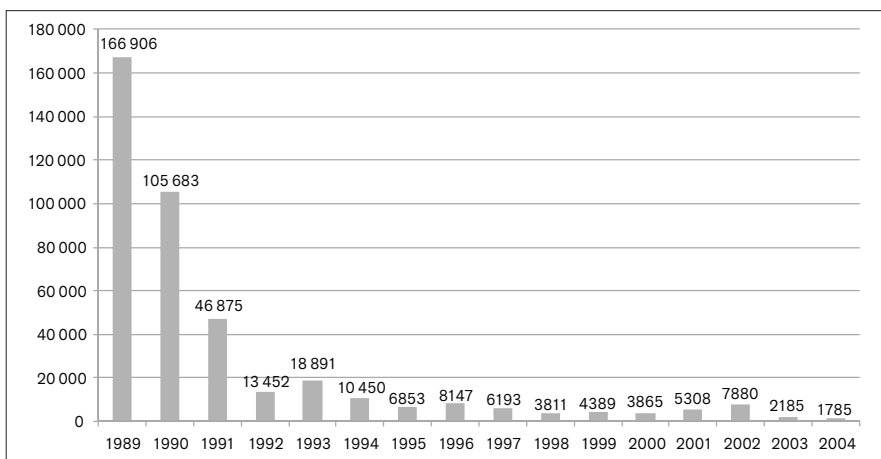
Table 9.2: Shoe industry in the Czech Republic

	1989	1996	1999	2001	2003
Production of shoes (in million pairs)	73.1	25.7	13.5	12.5	7.0
Import of shoes (in million pairs)	10.9	23.8	30.0	35.9	44.5
Number of employees in the shoe industry (in thousands)	36	23	10.5	9.5	7.8

Source: Fránek (2004).

Another example of traditional Czech production that sharply declined after 1990 is manufacturing of motorcycles. The Czech Republic (Czechoslovakia) again used to be a significant motorcycle producer under socialism. Situation dramatically worsened after 1990 as we can see in Figure 9.3.

Figure 9.3: Production of motorcycles in the Czech Republic, 1989–2004



Source: Filipová (2008).

There are dozens of similar impacts of transformation on the enterprises. The consequence of these problems was pressure on the government to subsidize enterprises, but also adjusting to new conditions, looking for new markets, increasing unemployment, as well as facing higher indebtedness. State enterprises reacted to tougher conditions by increasing mutual indebtedness,

or by stopping paying suppliers (Chavance 1993). This is how suppliers got into trouble and how the problem of secondary insolvency arose. Some economists also point out the dramatic growth of mutual indebtedness of enterprises between 1991 and 1992 (Holman 2000; Sojka 2000; see also Table 9.3).

Table 9.3: Corporate indebtedness in the CSFR (in billions of CZK)

	Debt in banks	Inter-enterprise debt
1989		
December 31	530.8	6.6
1990		
June 30	533.5	14.5
December 31	536	46.8
1991		
June 30	611.3	123.5
December 31	646.8	170.6
1992		
March 31	654	170.2
June 30	628.7	n.a.

Source: Frydman, Rapaczynski and Earle (1993).

9.3 Establishing new enterprises

One of the fundamental changes after November 1989 was the liberalization of entrepreneurship. In 1990, laws legalizing private ownership and business were passed. It was reflected in the immediate increase in the number of entrepreneurs. The number of individual entrepreneurs increased from 157,547 at the end of 1990 to 1,152 million at the end of 1991, and to 1,423 million in mid-1992 (Frydman et al. 1993). I should note, however, that many of these entrepreneurs were active only partially. The authors maintain that only 10–30 percent of the aforementioned number performed their activity as their main occupation. The situation with the total number of economic subjects was similar. At the beginning of 1990, there were only 18,837 economic subjects in the CR—1,576 state enterprises, 1,069 cooperative farms, and the rest were communal service enterprises, production cooperatives, budgetary and allowance organizations, and the private sector. But then the number of the subjects quickly increased and at the end of 1991 there were nearly one million of market units in the economy. For the development of the number of businesses, see Table 9.4.

Table 9.4: Number of businesses in the CR at the end of the period

Total *		From it according to legal form					
		Private entrepreneurs		Trading companies		Cooperatives	State companies
		Total	from it registered in commercial register	Total	from it Joint stock		
1989	18,837				43		
1990	178,993	124,455			658		3 505
1991	955,647	898,564	9,615	23,112	2,541	3,977	3 737
1992	1,118,637	1,029,343	15,622	39,495	4,076	4,041	3 272
1993	1,250,216	1,114,621	14,068	60,376	4,813	4,617	2 920
1994	1,118,534	938,221	13,034	88,424	6,017	5,214	1 522
1995	1,321,096	1,093,151	14,662	112,514	7,564	6,172	1 003
1996	1,468,940	1,202,097	15,227	130,626	9,255	6,806	694
1997	1,627,626	1,323,364	14,370	145,859	10,353	7,826	550
1998	1,781,334	1,429,946	13,472	165,123	11,697	9,276	332
1999	1,963,319	1,528,151	13,770	188,058	13,009	10,236	255
2000	2,050,770	1,572,917	15,886	204,075	14,092	11,007	200
2001	2,121,562	1,624,445	20,231	214,637	14,845	11,536	177
2002	2,223,745	1,708,204	21,389	220,461	15,260	12,085	145
2003	2,325,977	1,771,945	20,822	232,204	15,903	13,078	126
2004	2,352,601	1,770,014	18,696	244,537	16,403	13,334	107

* numbers of registered units also include allowance organizations, schools, foundations, and so on.

Source: Czech Statistical Office (2001).

Two factors played a role in this development—one was the small and mass privatization; another was the relatively easy conditions for the establishment of new companies. In small privatization, a large number of subjects became independent. The mass privatization had similar consequences—privatization proposals often counted on breaking up large state enterprises into smaller units.¹⁰ All that was necessary to establish a limited liability company was 100,000 CSK (USD 3,500). The government wished to increase competition and unbind private initiative. However, not everyone agreed with this approach and protested against low costs for establishing a limited liability company and a joint stock company, because he thought the business freedom of these subjects was not balanced with responsibility (Mlčoch 2000). Toward the end of the decade, the situation became different—conditions for business were

getting harder, administrative costs were growing, more businesses were categorized as licensed, and so on (see, for example, Schwarz 1998; Tříška 1999).

9.4 Restructuring of enterprises

One of the hot topics in economic discussions during the transformation was restructuring. I think part of the problem is the fact that the term “restructuring” is not clearly defined—in fact most authors use the term without defining it. It is therefore difficult to assess whether the restructuring was underway and whether it was successful. Let us therefore first define the term.

9.4.1 Definition

In general, restructuring means “changing of a structure.”¹¹ In relation to the microsphere, the restructuring is related to changes within enterprises, which should eventually lead to their better performance. These processes are underway permanently in all economies. It is obvious that Czech enterprises in 1990 needed to change the structure urgently, because they were ineffective—often loss making, manufactured products that nobody wanted, wasted resources, and so on. Myant writes that enterprises often underestimated the need for change (Myant 2003). Enterprise managements often believed that their products were state of the art—this opinion was widespread in mechanical engineering. The managements also believed that they were able to overcome problems less painfully than by deep restructuring. In my opinion, restructuring is a process that should lead to more effective production. How should such a process proceed? It involves several levels—dividing large enterprises, dismissing of redundant labor, and closing of loss-making plants or parts of the plants. How can we measure whether the process of restructuring is underway? The profitability of the enterprises could be a certain indicator, but it is difficult to measure globally. We should therefore consider “indirect proofs,” especially unemployment (it should grow); number of enterprises (it should increase); orientation of foreign trade (toward more demanding foreign markets); number of bankruptcies (should be high); and changes in the share of individual sectors in the GDP (should be changing).

9.4.2 Dispute about restructuring at the beginning of transformation

Practically all authors agree on the necessity of restructuring. The disputes concern the sequence of steps—namely, whether the restructuring should occur before or after privatization, which was closely related to the dispute about whether restructuring should be done by the state or by the new owner. For example, Sojka is convinced that restructuring should precede privatization (Sojka 2001). Levčík also spoke in favor of restructuring at the beginning of transformation (Levčík 1992; see also Pick 2000). By contrast, Klaus often spoke against state-implemented restructuring. In 1992, he documented that it was absurd for the state to restructure enterprises before privatization, because if it had been capable of doing so, it would not need to sell them in the first place. He claimed the situation was quite the opposite—the state was not able to manage enterprises and thus it was not able to save them either (Klaus 1992). In 1995, Klaus wrote that the state would not carry out restructuring because bureaucrats would never know as much as the owners of enterprises (Klaus 1995b). And, besides, the government did not want to intervene in the functioning of the microsphere. Holman wrote that the state cannot restructure enterprises effectively—it cannot close factories, lay off employees, and change the assortment of products, because the state does not have qualified employees and it cannot motivate them to handle such an immense task either (Holman 2000). This is why, he claims, it was necessary to privatize and the new owner was expected to carry out the restructuring. Tříška notes that the principle of voucher privatization was to sell without restructuring, mainly because it was simply impossible to restructure 1,492 enterprises (Tříška 2002). Another viewpoint claims that if massive restructuring occurred at the beginning, it would have been necessary to close most enterprises and fire employees (Hrubý and Rudlovčák 2002). But the Czech reform, they claim, proceeded so that “the effectiveness was never fully enforced,” and the country was getting rid of its ineffectiveness slowly, without causing social and economic catastrophes.

In this discussion, I am fully on the side of the advocates of postprivatization restructuring. How did their opponents imagine the situation in which the enterprises are restructured first? Restructuring means firing redundant employees, closing ineffective productions, and breaking up large enterprises. Let us imagine a situation in which state bureaucrats come to a company and say to close this and that plant, make this part of the company independent and fire 40 percent of employees, because we know that the

remaining productions will be profitable. I am repeating Skála's question: "Can a state officer restructure enterprises?" (Skála 2003). And how would a state officer acquire background information for his decisions and how would he justify and enforce them? My opinion is that the bureaucrats were not prepared to make decisions about laying off or closing factories (i.e., the key restructuring measures). They would not be able not to make such decisions now, let alone in the early 1990s—let us not forget that these were the same bureaucrats who made decisions about central planning, regardless of any market, profitability, or effectiveness. Mlčoch believes that the government should not operate on the micro level and should sign contracts with managers, which would motivate them to carry out restructuring in the companies (Mlčoch 2000). It is rather questionable whether state clerks would be able to do it and it would have been extremely difficult to prevent the managers to take the property into their own pockets.

Or was it supposed to be financial restructuring? If it were to be so, the question is how does one choose enterprises suitable for this form of restructuring, as if it were any different from the previous practice of subsidizing? We must also ask where the money would come from; there is no other option than transfers from successful to unsuccessful enterprises. Klaus was against financial restructuring, claiming that the gain from the transaction would be lower than the expenses (Klaus 1995b). Moreover, state-implemented restructuring on such a grandiose scale was impossible. This is why it was used seldom and enterprises were mostly privatized as they were, while saving was left to new owners.

However, the real strength of the government was another question. I agree with Holub, who writes that the role of the government in the restructuring process is always problematic, because despite the declared unwillingness to restructure, the government was ever more willing to help the companies (Holub 1996). Tříška notes, for instance, that in the very successful privatization of Škoda Auto (AZNP Mladá Boleslav), the enterprise was sold "purged" (Tříška 2002). I could speak about dozens of examples where the state helped various companies, such as Zetor, Tatra, or Škoda Plzeň. Similarly, Orenstein (2001) writes about the active effort of the government to prevent large enterprises from falling. Even Klaus, in the previous quotation, admits exceptions from his strict attitude.

Nevertheless, in the core of the discussion about restructuring I find again the role of the government and whether it is trusted or not. The believers in

the state trust the government to be able to do restructuring in the state-owned companies. The proponents of the markets mistrust the government and state clerks in doing something that they had not been able to do in the previous forty years.

9.4.3 How did restructuring proceed?

What was the practice of restructuring? And how did it differ from theoretical considerations? Disputes about the existence and measure of restructuring raged for a long time. In the long run, it certainly happened, see the growing number of enterprises, the orientation of Czech foreign trade, which quickly changed to advanced markets,¹² or the general change in the structure of economy (subchapter 9.5).

On the other hand, the number of bankruptcies (see Table 10.6) and unemployment did not attest to any real restructuring. Unemployment remained very low for a long time (see Figure 5.8), which was perceived by many authors as a proof of slow restructuring (e.g., Fawn 2000; Krkoška 1999). On the contrary, Jonáš believes that the unemployment was so high that it was proof of undergoing restructuring (Jonáš 1997). Similarly, Holman presents numbers that, according to him, prove that the restructuring process was underway (Holman 2000).¹³ Table 9.5 also testifies to the claim that restructuring in some sectors was quite fast.

Table 9.5: Number of employees in the Czech steelworks (thousands)

Year	1989	1992	1995	1998	2000	2001	2002	2005*	2010*
No. of employees	136.6	104.7	77.1	58.4	43.5	30.6	29.8	26.6	23.7

* forecast

Source: Gottwald (2003).

Objectively, the total unemployment until the 1997 crisis remained low. Moreover, wages grew faster than work productivity, which was also perceived as a proof of slow restructuring (for example, Dlouhý 1999). It was the growth of unemployment after 1998 that was finally admitted as a proof of ongoing restructuring (*HN 2000 Yearbook* 2000; Pellešová 2003).

What was the task of the government in this process? Krkoška believes that the goal of the reformers was to change the role of the state in the

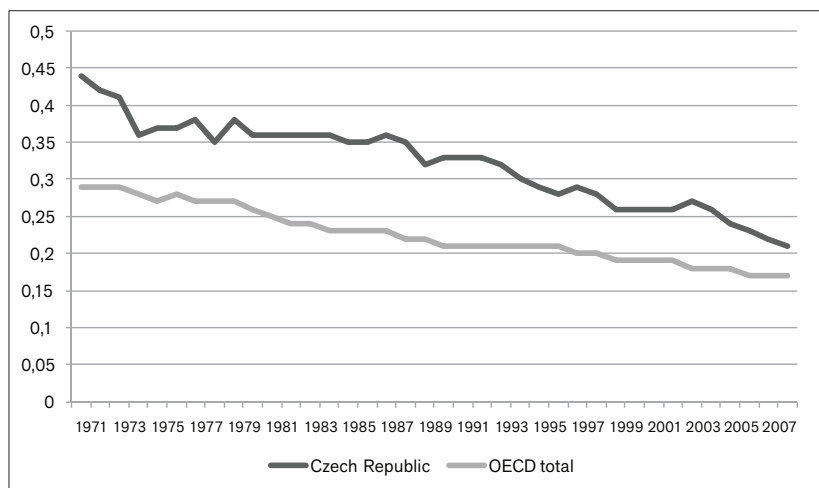
economy and to implement the market system immediately, which was supposed to force the companies to restructure (Krkoška 1999). Holman maintains that the privatization in itself was important for the restructuring of enterprises. Enterprises were being split into smaller independent units, and “everything was so widespread and quick that the state organs would never have been able to do it” (Holman 2002). He writes that the enterprises could not restructure before privatization simply because they were unable to sell useless property—only during the major privatization, when each building found its owner, land, property, and capital markets began to emerge together with a real capital market. Similarly, Loužek writes that the voucher privatization led to the division of enterprises into smaller units, reorientation of trade toward western markets and higher unemployment (Loužek 2001).

Critics have exactly the opposite opinions and point to privatization as an obstacle to restructuring. For example, Spěvák believes that slow restructuring was a consequence of the chosen privatization method, insufficient capital, and poor managerial skills (Spěvák 2001). Pick claims that the restructuring was not implemented because of the emphasis on the quick pace of privatization (Pick 2000). Other criticisms are more general. Dobešová and colleagues write that conditions for effective restructuring were not created (Dobešová et al. 2003). Dillon and Wykoff affirm that Czech enterprises did not use the era of undervalued currency to carry out reforms (Dillon and Wykoff 2002). The state was against bankruptcies and the banks kept lending—the pressure on the enterprises to restructure did not exist (see also Dědek 2000).¹⁴ Simonson sees the roots of slow restructuring in slow privatization of large Czech banks; or in the fact that large banks, controlled by the state, supported old enterprises (Simonson 2000). Still others criticize that restructuring consisted in canceling of non-effective productions, instead of replacing them with more effective productions (*HN 2000 Yearbook* 2000). Energy dependency can be characterized as one of the indirect indicators describing restructuring (see BOX 56).

BOX 56 Energy dependency

Restructuring should fructify in decline of the enormous dependency on energies in the Czech economy. This dependency on energies declined significantly during the transformation (see Figure 9.4). The values generally converged to the OECD average but in 2004 they were still substantially higher.

Figure 9.4: Tons of oil equivalent per 1,000 USD% of GDP calculated using PPPs in the Czech Republic and in OECD countries, 1971–2007



Source: OECD (2010).

Table 9.6: Share of the biggest companies in total production and employment in manufacturing industry, 1989–1997

	1989	1992	1994	1997
Share in total production				
5 biggest companies	9.5	12.4	15.2	16.6
10 biggest companies	17.8	22.6	21.3	21.8
20 biggest companies	26.8	29.3	26.9	27.2
50 biggest companies	41.9	40.8	36.3	36.5
100 biggest companies	55.2	51.9	45.6	45.5
200 biggest companies	72.6	65.3	57.8	56.3
Share in total employment				
5 biggest companies	9.5	8.9	7.5	6.8
10 biggest companies	15.1	13.3	10.7	9.6
20 biggest companies	21.1	18.7	15.1	13.3
50 biggest companies	33.3	28.7	23.6	20.6
100 biggest companies	47.4	40.2	33.6	29.3
200 biggest companies	66.0	52.2	46.5	40.8

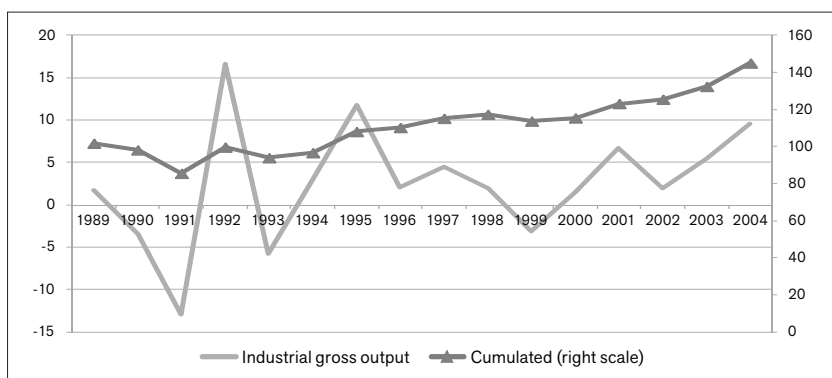
Source: Zemplerová (2005).

Another measure that testifies the progress of restructuring is the level of the market concentration in the economy. We can expect that concentration should decline from the very high levels at the end of the communist reign. These expectations were fulfilled in reality only partially until 1997, according to numbers provided by Zemplinerová (2005; see also Table 9.6). The table shows that the share of the five biggest companies actually increased but the share of a large number of companies substantially declined. It seems that we can interpret it as a kind of proof of restructuring in the Czech economy.

9.5 Development in various spheres of business activities

Figure 9.5 depicts development of the industrial sector during the transformation process. We can see that industrial production declined alongside with the transformation recession and then again in 1993. Dobešová writes about the elimination of unwanted production, limiting production of uncompetitive products; decreasing the importance of heavy industry and phasing out military production, which played a major role in the drop of industrial production (Dobešová 2000). Another slump was connected with the economic recession in 1997–98. Overall, however, the Czech industrial production increased. The average growth achieved 2.6 percent per year (see Figure 9.5). It should be pointed out that rise of exports played a prominent role in this growing trend.

Figure 9.5: Changes in gross industrial output per year and on cumulative basis, 1989–2004 (1989 = 100; in %)



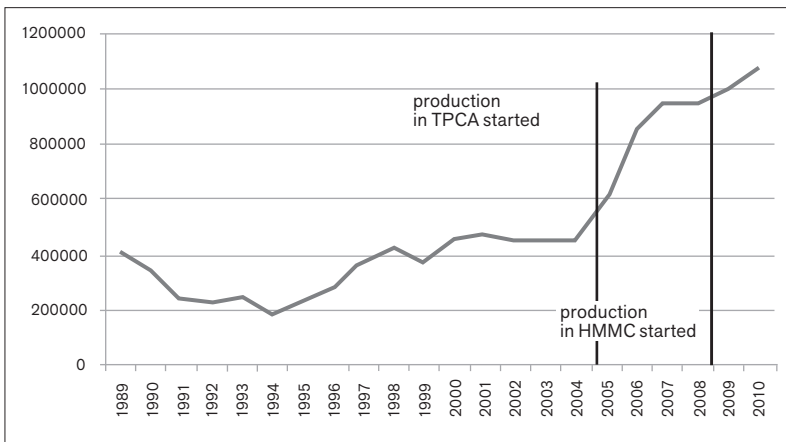
Source: EBRD (2008).

There were several new industrial branches that began to gain importance—especially the aviation, car making, electronics, and selected military industries. One of the most successful was car production (see BOX 57).

BOX 57 Development of the car industry

Car manufacturing was an important industry in Czechoslovakia during the central-planning period. At the end of the 1980s the production reached over 400,000 vehicles (see Figure 9.6). Then the production declined even after Volkswagen purchased the Škoda Auto in 1991. It started again to grow only in the middle of the first transformation decade. There were other important foreign investments in this industry—Volkswagen was followed by for example Continental Teves in 2000, Bosch in 2000, Toyota/PSA (TPCA) in 2002 (production started 2005), and Hyundai Motor Company (HMMC) in 2006 (production started in 2008). These foreign direct investments played a crucial role in the increase in the production of cars and car components in the country.

Figure 9.6: Production of cars in the CR, 1989–2010¹⁵

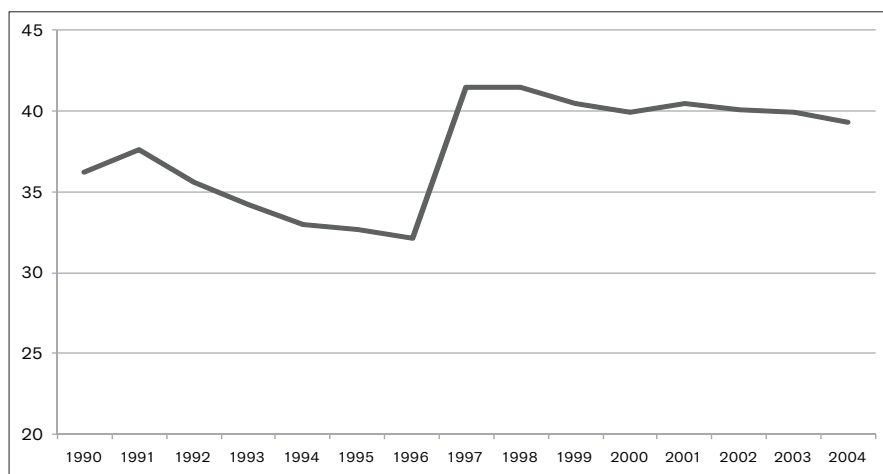


Source: Sdružení automobilového průmyslu (2011).

This development meant increasing dependence of the economy on the car production. The car industry created roughly 14 percent of the Czech industrial production in 2004. The Czech economy qualified into a group of large car producers, but there are views that the economy became over dependent on the car industry.

There was another interesting aspect of the industrial sector development—the share of the industrial employment in the total employment. The share declined but then in the second half of the 1990s again increased (see Figure 9.7). It stays relatively high in the rest of the period.

Figure 9.7: Share of industry in total employment, 1990–2004 (in %)

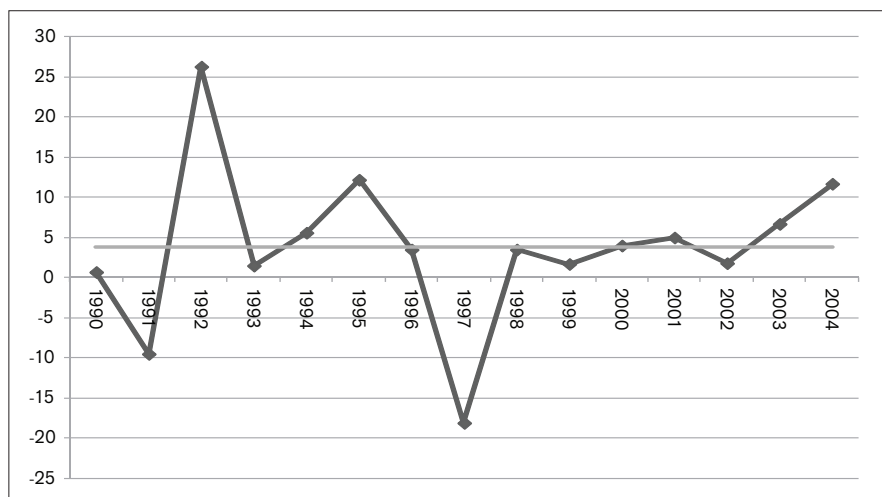


Source: EBRD (2008).

Successful transformation should lead to improvement in productivity. Figure 9.8 depicts development of productivity in the industrial sector during the transformation period. We can see that there were two slumps connected with the economic decline—during the transformation recession and then during the recession in 1997. But on overall productivity in the industry was growing—on average increased by 3.8 percent per year (EBRD 2008).

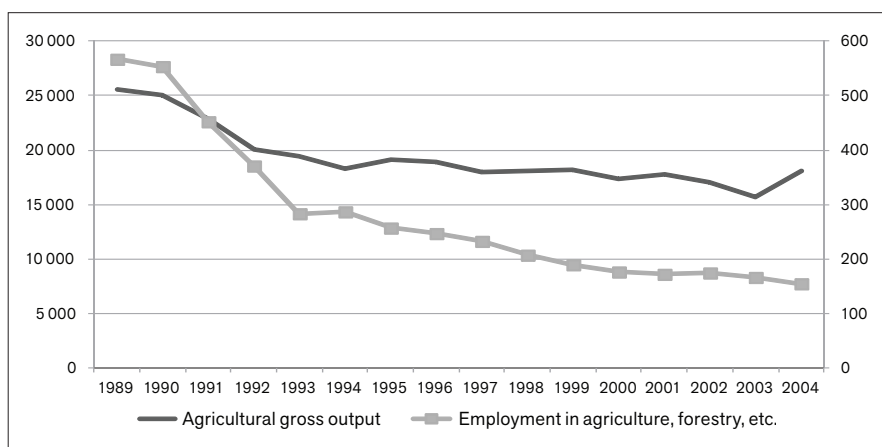
I also address here the development of the agricultural sector. There was a sharp decline in the gross agricultural output in the first years of the transformation (see Figure 9.9). Then the production roughly stabilized in the middle of the first transformation decade. Meanwhile employment in the sector slumped from 550,000 employees in 1990 to nearly half of that—280,000—in 1993. This trend continued in the following years. In 2004, slightly more than 150,000 employees worked in this sector. The plunge in employment was much lower than the decline in output and it means that productivity in the sector increased, between 1990 and 2000 it more than doubled and by 2004, it increased 2.6 times (ČSÚ 2011).

Figure 9.8: Change in labor productivity in industry and average growth of productivity, 1990–2004 (in %)



Source: EBRD (2008).

Figure 9.9: Gross agricultural production per 1 hectare (constant prices 1989=100); employment in the agricultural sector (in thousands of employees)

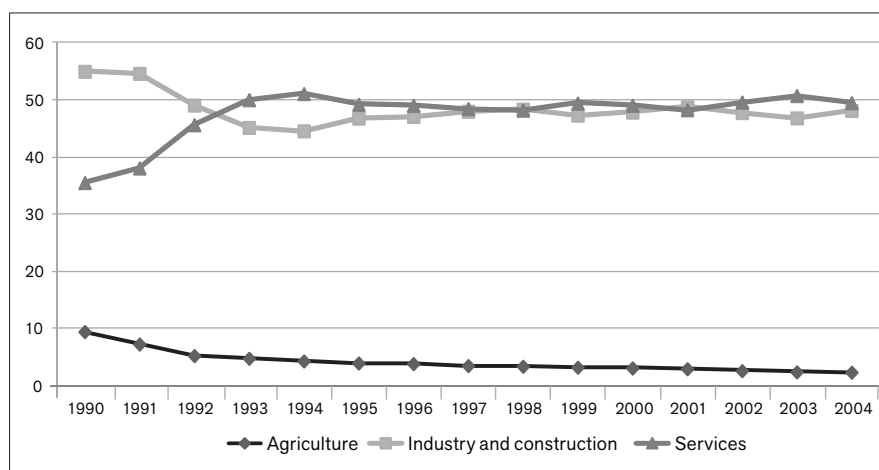


Source: ČSÚ (2011).

The development in the individual sectors led to overall changes in the structure of the Czech economy. The economy headed toward a modern structure.¹⁶ The share of agriculture was dropping, while the share of services increased in the first years of the transformation. However the changes in

the structure were mainly due to the drops in industrial and agricultural productions rather than the increase in services, because these two sectors were the most hurt by the transformation recession. In the advanced countries it was the other way round—the sector of services grew faster than the industrial sector and this led to the emerging of the modern structure (Spěváček 2001). By contrast, the share of industry at the beginning of the transformation was high (see Table 1.1) and the development is therefore not surprising. But later on, the growth of the share of services stopped and the sector had roughly the same share as industry. This development testifies the lasting importance of industry for the Czech economy. At the end of the transformation period, the share of services was still significantly lower than in most advanced countries, where it often exceeded 70 percent of GDP. The course of the changes is summed up in Figure 9.10.

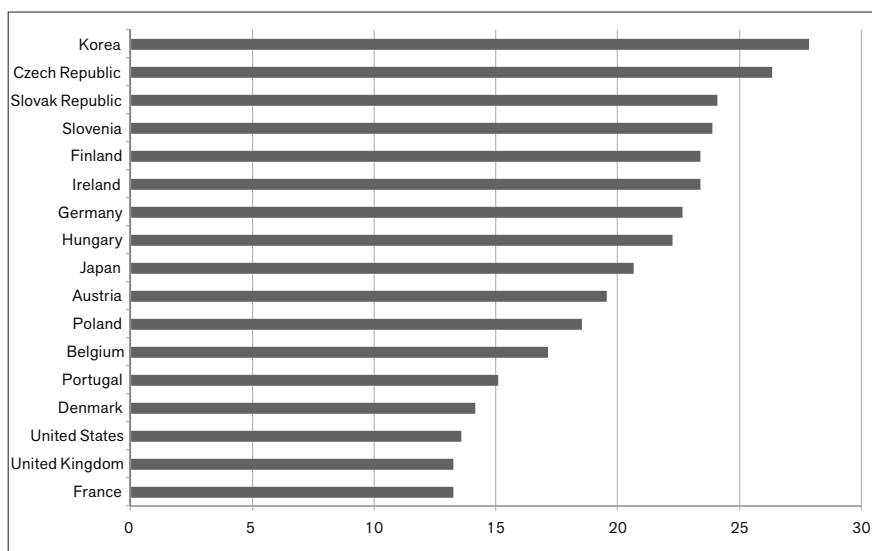
Figure 9.10: Branch structure of Czech production, 1990–2004 (% of current prices)



Source: ČSÚ (2012).

On the contrary, the share of industry in the economy was still relatively high if we compare it with other developed countries. We can see the basic comparison with the selected OECD countries in 2005 in Figure 9.11. The share of industry in the Czech economy was the second highest just after Korea.

Figure 9.11: The share of value added in industry to total economy in 2005 (in %)



Source: OECD (2011).

The share of agriculture declined during the transformation period, while the share of services in GDP (and of employment) was increasing (see Table 9.7). This development is not surprising if we consider the attitude of the former regime, which perceived services as being nonproductive. Services developed quickly in many areas—trade, banking, tourism, restaurants, real estate, leasing, auditing, advertising, tax consulting, and data processing. In the initial phases of economic transformation, services absorbed a large portion of the dismissed workforce.

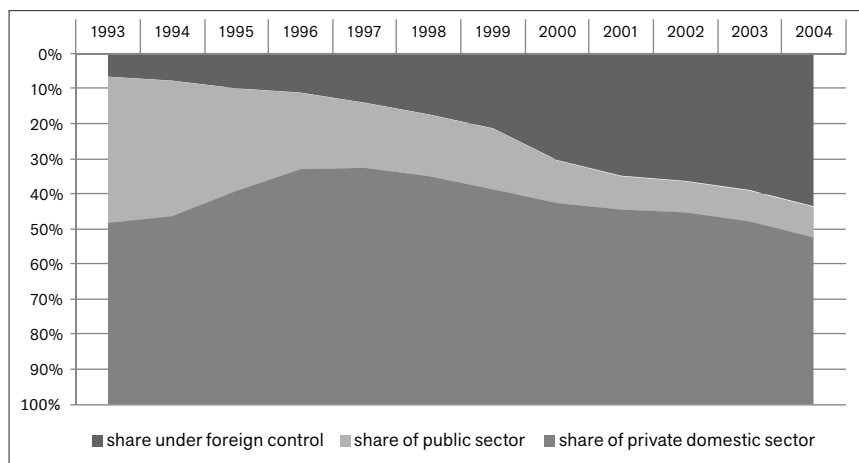
The last interesting aspect of changes in the Czech production is the growing role of foreign companies in the economy. This development is a consequence of privatization and foreign direct investment into the economy. We can see the main trends in Figure 9.12. Unfortunately, data are available only since 1993. The figure depicts decline in the share of public sector companies—it created 41 percent of nonfinancial production in 1993 but this share declined to just 9 percent in 2004. Meanwhile, the share of foreign companies increased from mere 7 percent to 44 percent in the same period. This trend continued in the following years. The share of domestic private companies first increased at the expense of the declining government share but later on declined again as a consequence of a growing role of foreign companies.

Table 9.7: People employed in the national economy, 1990–2004 (thousands)

	1990	%	1995	2000	2004	%
Agriculture	518	9.9	230	186	152	3.8
Industry	1,752	33.5	1380	1,293	1243	31.2
Construction	449	8.6	435	301	292	7.3
Trade and hotel services	693	13.3	673	605	616	15.5
Transportation and telecommunications	375	7.2	365	358	353	8.9
Services for enterprises, real estate, research	353	6.8	306	293	290	7.3
Education	285	5.5	287	268	274	6.9
Health sector	308	5.9	284	245	239	6.0
Public administration, defense, welfare	291	5.6	290	298	307	7.7
Financial sector, insurance	26	0.5	61	79	68	1.7
Waste disposal, social organization, culture, sports and other	178	3.4	141	150	151	3.8
Total	5,228	100.0	4,452	4,076	3,985	100.0

Source: ČSÚ (2012).

Figure 9.12: Shares of domestic and foreign companies in the Czech nonfinancial production, 1993–2004

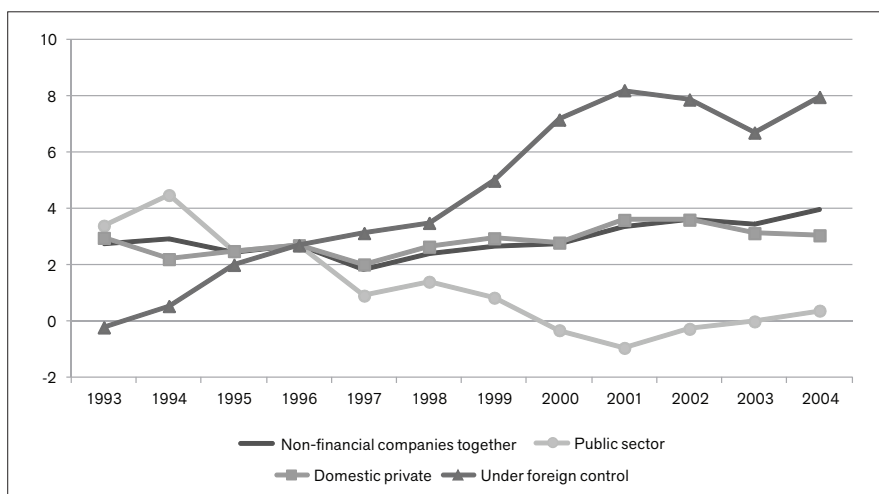


Source: ČSÚ (2012).

Generally speaking, foreign companies were more profitable than domestic ones. Figure 9.13 shows that profitability of foreign companies after 1996 was high and much higher than in other parts of the Czech economy. On the

contrary, and probably not surprising, profitability of the publicly owned nonfinancial companies was low and in several years even negative. The figure demonstrates the positive role of foreign companies in the Czech economy, and above all their impact on overall productivity.

Figure 9.13: Profitability* of domestic and foreign nonfinancial companies, 1993–2004 (in %)



*entrepreneurs income to actives rate

Source: ČSÚ (2012).

In this chapter I analyzed the position of companies during the transformation process. We became familiar with government steps that, on the one hand, helped the companies but, on the other hand, put pressure on them by increasing competition. The overall goal was to avoid collapse of the companies, while at the same time increasing their productivity as the only means of general improvement of the economy. In the core of the whole transformation on the company level was the process of restructuring. There was a stormy discussion about the role of the government. I am personally highly skeptical about the government's ability to execute this process.

I could see that the Czech economy was (and still is) highly dependent on the industrial sector. The role of services increased but it remained relatively low in comparison to other developed countries. And foreign companies became crucial for the functioning of the Czech economy.

Notes

- ¹ The Czechoslovak industry achieved only two-thirds of the productivity of advanced European countries, owing to outdated technology and poor organization (Myant 2003).
- ² Holman writes that these concerns were expressed already in the Czech government proposal in the spring of 1990, which supposed careful opening of home markets (Holman 2000). Slaný claims that the proposal included two versions, with one assuming concurrent liberalization of trade and prices (Slaný 2003).
- ³ In addition to the reform measures proper, enterprises faced other problems, related to the disintegration of foreign markets, and the loss of potential markets.
- ⁴ According to some economists, there was a pressure on the banks to award loans (for more on this topic, see Konkolská and Mielcová 2001; see also Chapter 8 in this volume).
- ⁵ Such terms as structural or microeconomic policy are used interchangeably. On the nonexistence of structural policy, see for example Sojka (2000); on the nonexistence of microeconomic policy, see Dobešová et al. (2003).
- ⁶ Conversely, Klaus claims that the government implemented numerous measures helping the enterprises—the country had a stable currency; special institutions (organizations) were created, such as EGAP, Support and guarantee agricultural and forestry fund, and Českomoravská záruční a rozvojová banka; the government also tried to lower taxes (Klaus 1994).
- ⁷ I think that “industrial policy compatible with the market” is a contradiction in terms. Market forces bring about a certain state of affairs. If the state intervenes in any way, it is not the result of market forces anymore. In principle, the state policy changes market results and thus can hardly be compatible with the market.
- ⁸ Myant further maintains that the company survived only owing to the state, which took over its debts (Myant 2003).
- ⁹ The Czechoslovak shoe-making industry reached its peak in 1985, when 131.4 million pairs were made (Simonian 1994).
- ¹⁰ This process was taking place in 1990–92. At the end of 1989, only 720 industrial enterprises existed in Czechoslovakia, but at the end of 1992, the number was over 2,500 (Kočenda and Lízal 2002).
- ¹¹ Some economists view financial restructuring as purging of debts (e.g., Klaus 1995b; Schwarz 1997; Tříška 2002).
- ¹² Indirect proof was provided by Dillon and Wykoff—otherwise critics of slow restructuring—who noted that in 1990 there were only fifty-two foreign trade enterprises in the whole country, while in 2002 there were already thousands of them (Dillon and Wykoff 2002).

- ¹³ Employment in the industry between 1990 and 1993 decreased by only 15.6 percent, while the industry dropped by 32 percent, but in 1994–95, the industrial production increased by 11.7 percent and the employment in the sector dropped by 2.9 percent (Holman 2000).
- ¹⁴ The authors even claim that the monetary crisis originated as a result of slow restructuring.
- ¹⁵ I decided to depict a longer period because of an interesting development after 2004 that was de facto based on investment from the period prior to 2004.
- ¹⁶ Modern structure of the economy is a term that describes the state in which services play a decisive role, industry plays a smaller one, and the agriculture plays the smallest role. Achieving of the modern structure of economy is sometimes deemed as a condition of the advanced status.

DEVELOPMENT OF INSTITUTIONS

One of the hottest topics in the whole transformation process in the Czech Republic was the development of institutions (see Chapter 1 for the definition of the term). I understand them as broad rules in the society that can be formal (codified) as well as informal (not defined by state—for example customs).

The specific impact of institutions on the economy is unclear. But most economists believe that institutional environment is the key factor for a long-term ability to grow. Take for example the legal system. Its functioning influences the willingness of the companies to take risks. The companies need to be sure that in case of problems (for example the partner does not pay for the product) the legal system will be on their side and quickly solve the dispute. The legal system has to assure property rights and order in the economy and this influences, for example, investment. The institutional environment affects productivity of the factors or the long-term potential growth of the economy (see, e.g., North 1992).

The state of the institutional environment at the beginning of the transformation process was feeble because the institutions were unsuitable for the market economy. Thus the change of the institutional environment was a monumental task that stood before the politicians, economists, and in a broader view before all the inhabitants of the country. Thus this chapter focuses on the development of the institutional framework. I progress from the general topics of overall institutional development. Then I distinguish between formal and informal institutions and later on concentrate on more specific topics that I deem crucial for a well functioning market economy. In particular I analyze the development of the global legal environment, bankruptcy law as an important part of the legal environment, corruption, and the entire market environment.

10.1 General institutional development

The change of institutions after 1989 is a complicated process. Klaus was aware of the complexity of the task, when he wrote that the revolution was easy—much easier than to create new institutions, define new rules, and enforce new behavior patterns in the economic sphere (Klaus 1992).¹ Melecký observes that if the Czechoslovak economy was the most developed transforming country economically, institution-wise it was nearly the most backward (Melecký 2003). Further, Chavance writes that although the planning institutions were abandoned, the deeply rooted behavior patterns survived (Chavance 1993). Klvačová mentions that the economic transformation destroyed the socialist institutional frame, which was later replaced with a temporary frame for the transitive period (Klvačová 2002). Tošovský expresses similar views when he writes:

In advanced market economies, institutions, legal frame, formal and informal standards and ethics are a product of permanent gradual development, which takes decades to develop. But the economic transformation in transitive economics required abandoning current institutions, laws and standards, and replacing them with new ones. (Tošovský 2000)

Mlčoch brings up the fact that a sudden change of institutions destabilizes society and economy, threatens the social order, and disrupts moral standards (Mlčoch 2000).

How are institutions changed? According to Mlčoch, there are four basic approaches (Mlčoch 2000). The liberal or pragmatic approach, when institutions copy proven successful models. He labels this approach “institutional Xerox.” The conservative approach, which involves returning to institutions used before the centrally planned economy, was implemented. Critical realism approach reacts to the criticism of current capitalist institutions and therefore it tries to create an institutional system, in which improvement proposals are implemented. And the last approach is the “third or fourth way.”²

Transformation governments changed the institutional frame intensively. Since the second half of the transformation decade, the strategy of the previous right-wing governments was widely criticized for neglecting the institutional change.³ Melecký writes:

Frequent corruption scandals, the stealing of privatized (and yet unpaid) property, the usage of gaps and inconsistencies in the legal frame, insufficiently defined ownership structure, absence of business ethic and other negative phenomena, which began to come through much more intensively in this era, became apparent in the growing criticism of the existing institution frame. (Melecký 2003)

Many domestic and foreign authors advocate these opinions. Vintrová writes that the weak economic growth is caused mainly by the delay in system and institutional changes (Vintrová 2003). Dillon and Wykoff also criticize the institutional environment (Dillon and Wykoff 2002). Mládek claims (although in relation to privatization) that there was insufficient will to build the institutions:

It can be said that a very strong feature of the establishment of that era was its lack of will to build institutions. It had two causes: on one hand, it was ideological naïveté, a belief that spontaneous order will create institutions automatically. The other moment was probably the acquisitive effort of some interest groups to paralyze institutions that might limit tunneling, “insider trading,” etc. (Vintrová 2002)

Urban writes about the absence of institutions and regulation mechanisms on the market and the lack of will to create institutions (Urban 2001). Similarly, Orenstein mentions that the neoliberals underestimated the institutional reforms, which they postponed for the “second stage” (Orenstein 2001). Even the central bank representative Tománek wrote about “reprehensible slowing of institutional reforms” (Tománek 2000).

In addition to this general criticism, I can also trace partial criticism—especially of the pace of the transformation process and of the economic theory, which was in the background of the transformation. The pace of transformation measures was also perceived critically. The main priority of the reforms was the pace, where economists wanted to be ahead of lawyers; consequently an effective institutional frame was not created (Pick 2000). Orenstein also addresses the speed of reforms similarly, pointing out that the effort was to carry out the reforms quickly, until there was the political capital for the change in the society (Orenstein 2001). But he also says that it was

impossible to reform the institutions quickly. Holub says that the shock therapy was chosen for the macro approach, while institutions developed gradually (Holub 1996). Tošovský mentions that it was a mistake to expect that an immediate implementation of quickly implementable changes (such as price liberalization) would mean immediate finishing all necessary transformation measures (Tošovský 2000). He claims many analysts come to a conclusion that the importance of institutions was underestimated in the beginning of the transformation.

Others offer a different theory, claiming that the entire neoclassical economic theory used as a basis for transformation, underestimates the role of institutions (e.g., Mlčoch 2000; Sojka 2000). These economists also say that this economic school does not count with the change of institutions. Sojka further writes that the mainstream economic thinking lacks the theory of evolution of institutions, which is the real content of transformation processes; it does not have any development theory; it focuses only on the macro perspective; it puts the market and the state in contrast (it does not count with the active role of the state in the economic development); and it has been created for stable market economy (Sojka 2000).

Other authors claim that there is a discrepancy between the theory and the transformation praxis. Critics must cope with the fact that the reformers were apparently under the influence of liberal economists, who put special emphasis on the law (e.g., Hayek 1993).⁴ Klvačová admits that the importance of institutional reforms was understood in the very beginning of transformation (Klvačová 2002). But, in practice, it received little attention compared to macroeconomic policy, both from international consultants and domestic politicians. Havel mentions that the Scenario of economic reform involves long passages about fundamental changes in the legal system (Havel 2004a). International recommendations did not neglect the institutional element either. But in reality, “noble” topics, such as monetary restriction, were closer to the hearts of Czech reformers than the business law or protection of the state property. Melecký comes up with a bold thesis that “intellectually, the importance of market institutions was admitted, but in content, institutional frame of the market remained very far from the reform progress” (Melecký 2003).

Similarly, Sojka writes that the government should create the legal frame to ensure the functionality of institutions, but the creation of the frame is not the business of the economists (Sojka 2000). Mainstream economy is

unable to provide theoretical background for a fundamental institution change. The author also writes that although some reformers were influenced by Hayek, in reality, the importance of ownership rights and of the theory of spontaneous order were ignored.

However, the reformers believe that the role of institutions during transformation was never underestimated. Klaus defends the liberal theory:

Liberalism is not an ideology of unrestricted freedom, and it never was. Great liberals of the past and the real liberals today have always emphasized that real freedom is only possible in connection with the rule of law. That is possible only when there is private ownership, free contracts and free access to the market, and if the state performs its basic function by protecting these institutions. (Klaus 1994)

Further, Fischer and Sahay document in their analysis⁵ that in the initial phase of the transformation in the Eastern Europe, foreign advisors and mainstream economists did not underestimate the importance of institutions and of the rule of law (Fischer and Sahay 2004). Some reformers are willing to admit institutional problems. But some argue that the Czech government had no explicit policy of neglecting institutional aspects (Dlouhý 1999). The fact that Czech politicians did not fully succeed in creating necessary market institutions was the result of “worsened political relations within the coalition, combined with the fact that the country and its politicians were less prepared for the change of legal and institutional frame than for the quick acceptance of the policy of stabilization and liberalization in the initial stage of the reform” (Dlouhý 1999).

I partially agree with Havel’s assessment:

Although serious reservations that the tempo of institutional changes in the CR was insufficient and underestimated can be accepted, no one should claim that some institutional God could have created such an environment in advance: it is simply an illusion. Institutions are created and developed by being used, through the mechanism of mutual interaction with the reality. It takes not months, but decades or even generations to build institutions. Of course, this statement is no excuse for us in many regards. (Havel 2004)

The question is: How much better could the institutions have been? My view is that the criticism of institutional environment has its roots mainly in the disappointment from the regrettable state of informal institutions (morals). The state of informal institutions led to negative manifestations such as tunneling and corruption. Increasing crime rate also brought disappointment, but in a society which threw away the totalitarian practices it could hardly have been avoided. Last but not least, economists appeared to be disappointed with the functionality of the legal framework and law enforcement (see 10.3).

Mlčoch wrote that the defects of the previous regime live on (Mlčoch 2000). Sojka interestingly claims that neoclassical theory lacks the adequate role of the state in economic development, which he deems necessary (Mlčoch 2000; see also Sojka 2000). In my opinion, this aspect is the cornerstone of most of the criticism. The reformers insisted, at least formally, on the weak role of the state. I think that the core of the dispute is again in the different approach to the role of the state in the economy; considerations about the underestimation of the institutions are largely just a pretext for criticism.

It is obvious that not everything in the Czech institutional environment was in order. But was the Czech environment really as bad as the critics claim? If it were so, how come the CR has the highest inflow of foreign direct investment per capita in the entire Eastern Europe, which was also true for the 1990s? If the foreign investors are really particular about something, it is the institutional environment. Ironically, the strongest wave of criticism collided with the period of massive inflow of foreign investment. I believe that the critics were impatient, if anything. Let me remind the reader what Tošovský writes: “in advanced market economies, institutions, legal frame and both formal and informal standards and ethics are the product of continuous gradual development that lasted for decades” (Tošovský 2000). Critics were disappointed that institutions did not function six or seven years after political change that meant fundamental institutional transformation!

I will later discuss specific selected aspects, such as legal environment. But let us first talk about one more general topic—formal and informal institutions during the transformation.

10.2 Development of formal versus informal institutions

Critics of the institutional development often do not discriminate between formal and informal institutions. We would like to point out that formal institutions are devised by human beings and are codified by the government; for example, legal system. The informal ones are not defined by the state—these involve for example customs and morality (North 1990). In my view without this distinction we are not able to discuss the transformation development. From a critical standpoint, the government or reformers are responsible for the entire development of the society. This division is used by only a small group of economists, most of them inclined to support the Czech version of transformation (for example, Holman, 2000). Havel writes:

No matter how clear it is that there is a formally legal definition, this definition has very volatile consequences in practice, because the written law in the initial phase of the transformation is not settled and lacks authority. It either cannot be enforced at all, or in the short time horizon that does not have any economic meaning.⁶ (Havel 2004)

Others also pointed out the discrepancy between formal and informal institutions after 1989 (Jonáš 1999; Tošovský 2000). Klaus, in defense of his policy, mentions that the conflict between formal and informal rules in the CR was very likely to happen (Klaus 1999). He also asks what was worse: whether defects in legislation, or the discrepancy between formal and informal institutions. Havel also mentions this discrepancy:

The enforcement machinery always lags behind in quantity and cannot work effectively if the frequency of the breaking of standards is so high that it becomes a standard in itself. It can thus be said that a condition of a functioning law is a certain degree of a functioning morality. (Havel 2004a)

Klaus has a similar opinion:

Social reality was changing in leaps (and it still is). The legal frame was set up for a completely different reality, and although it transforms quickly as new laws are being created, the gap between reality and the legal code remains wide. This leaves a rather large room for the activities that are not

sanctioned by the legal code (notwithstanding the poor quality of institutions that enforce it) and it is quite natural that this free space is quickly filled up with human activity, which is obviously and justifiably considered unacceptable, unjust, immoral, destructive, etc. (Klaus 2000a)

It is rather surprising that the critics of the transformation development do not consider the division of institutions, although it must have been obvious to them. My opinion is that numerous problems stemmed exactly from the informal institutions (e.g., tunneling; see BOX 58), while the government had very little power to do anything about it. Let us not forget the situation at the end of the totalitarian era. In the first chapter, I discussed its moral problems. The popular slogan was “those who do not steal from the state, rob their families”; (even) vegetables were sold “under the counter” and the entire nation was forced to live in a lie. Hard to expect that someone “waves the magic wand” and the moral attitudes change in an instant. However, Klusoň blames the government for the bad moral state of the society:

I am asking why the authors of the government scenario of the economic reform did not realize (or did not want to realize) the moral hazards involved from the beginning; how could they ignore the danger that the transformation to market economy with massive property transfers would offer unique opportunities for enriching those who do not hesitate to break not only the law, but also basic norms of morality, oscillating around the Decalogue commandment: Thou shall not steal!, which should be a binding norm not only for religious people, but for all decent citizens. (Klusoň 2004)

I am not a philosopher, but I assume that it is impossible to change the morality and customs simply and quickly. I like what Dahrendorf said:

In his considerations about the revolutions in Europe in 1989 Ralf Dahrendorf formulated the thought that the transformation of post-communist societies to the western-type societies will occur in three phases: administrative, economic and psychological. While the administration change and the creation of democratic institutions will take six months, the economy will reasonably stabilize in six years, the behavior patterns and settled values will take sixty years to change. (Nohejl 2004)

Mlčoch notes critically that the reformers did not pay much attention to morality (Mlčoch 2000). Melecký joins in the criticism of the moral condition of the society (Melecký 2003). However, paraphrasing Klusoň, I am asking: what can a government do about the moral state of the society (except for setting an example)? It is true, that morality was not the topic of the day. Telling people: “behave ethically” was unlikely to stop those who did not intend to. Besides, it is not true that the reformers were not aware of the importance of morality. The importance of morality in the transformation cannot be overestimated because the market cannot work without morality (Ježek cited in Husák 1997). But he also claims that some reformers (e.g., Tříška) advocated privatization method “with the lights off,” enabling quick relocation of assets. If it really were so, such behavior could certainly be described as immoral. But otherwise, not a single reformer was ever even accused of any criminal activity. I doubt the reformers could have done more in this area. In addition, I think that criticism often came from people that had had entirely different expectations about the development of the transformation. For example, religious people are generally dissatisfied with the continuity of the secular society and with the state when the government did not support explicit religious values (Kučera 1998; Mlčoch 2000).

BOX 58 Tunneling

The term tunneling is frequently used in the assessments of the transformation (according to some, the term itself is a Czech invention). Critical notes about the tunneling are to be found in the texts of many authors (CNB 2003; Dobešová and colleagues 2003; Mládek 2002; Mlčoch 2000; Pick 2000; Průcha 2000). These cited authors do not provide any definitions, apparently assuming that the meaning of the term is generally understood. Other people are more specific. Kořená and Kořený define tunneling as taking out of assets from the company (Kořená and Kořený 2001); while Holman understands tunneling as the cheap selling of assets to one's own or friendly companies (Holman 2000). Sojka writes that the state stopped to exert its ownership rights, which was abused by the managers for tunneling, and Tříška associates tunneling with banks (Sojka 2000; Tříška 2002). Absence of a clear definition for such widely used term is surprising. In my view, the term is used to describe any immoral, but legally unpunishable activity that led to personal enrichment, usually taking out of assets from the company. It is something that is generally condemned, but also something that Czech legal code

could not define as criminal. The critics are mostly upset by the difficult sanctioning.⁷ Mlčoch wrote that lawyers gave preference to the written form, which dominated over the sense for natural law (i.e., justice; Mlčoch 2000).⁸ The tunnelers managed to use the gaps in laws and take away corporate or bank assets. How many tunnelers were sentenced? If the critics object that these people were personally related to right-wing governments, who protected them, such reasoning would hardly do for the social democratic governments. One of their preelection promises in 1998 was to punish the tunnelers, and the government launched the “clean hands” campaign right after the election. This campaign ended without any significant number of criminal acts having been brought to court (there were only one or two cases),⁹ even if the political will definitely existed. It is (in my view) an indirect proof that the so-called tunneling did not in most cases break any law.¹⁰

Another question is what percentage of the so-called tunneling cases was really governed by clear personal enrichment intentions. It is difficult to distinguish an intentional fraud from negative consequences of bad decisions:

Even in very advanced economies, with extremely well functioning infrastructure of legal institutions, it is not always easy to distinguish between a fraud and a business failure—unsuccessful businessman is by definition unable to meet his obligations, and this is why it is tempting to label him as a crook. (Triska 2002)

In addition, he points to the fact that frauds are as old as the banks themselves and quotes examples from France, Sweden, or Japan. Advanced economies are not free from frauds—see the latest examples from the United States and Europe, such as Enron or Parmalat. Similarly, the bond between companies and politicians is not exceptional either—just think of the Elf Company in France.

In my opinion, tunneling is the consequence of the discrepancy between formal and informal institutions during transformation and, in essence, it could not have been prevented. That the newly emerged legislation would be imperfect and that the people—especially Czech people—would be able to make use of the gaps was obvious from the start. It is hard to imagine how the courts would interpret the natural law when they had trouble interpreting individual legal acts. There would have been no unified legal interpretation. Yet the question remains why it took so long to fill some of the legal gaps for example, the light heating oils affair (LTO).¹¹

.....

After analyzing general attitudes towards institutions I now concentrate on four more specific topics—legal environment, bankruptcy law, corruption and the overall market environment.

10.3 Legal system

In the core of the functioning of the society as well as economy is the legal environment. Its quality and development were hot topics during the transformation period.

10.3.1 Development of the legal environment

The legal system inherited after 1989 was not suitable for a free society even if I ignore such extremes as the constitutional rule of the Communist Party.¹² The law and the entire legal system were subordinated to the Party's goals. Everything was designed with the aim to keep the Party in power. From the standpoint of the functioning of the economy, the laws were set up for the system of central planning. These laws were utterly different from the laws required in the market economy. Moreover, the entire execution of law in the economic area was influenced by the small number of market subjects (lack of competition); the fact that there were very few disputes between the subjects due to central control; and also by the fact that bankruptcies did not exist. Direct execution of the law (i.e., primarily the decision making of the judges) was also controlled by the Communist Party.

The need to reform the legal system was obvious from the very beginning of the transformation and it was incorporated in the reform plans in 1990. In the spring of that year, legal standards legalizing private businesses and ownership were passed. Dillon and Wykoff mention that immediately after the elections in 1990 an immense legal and institutional change had to be implemented; it was necessary to codify individual, political, and human rights, and the Constitution Court was established (Dillon and Wykoff 2002). The authors point out the very demanding work of the lawmakers; yet the same authors claim that the Czechs ignored the importance of restructuring of the legal system. However, to change the legal system was not an easy task. It was well-known at the beginning of the 1990s (Tříska 2002) and that some prob-

lems would be easy to remedy, while other tasks were more complicated; sometimes it would take intolerably long, for example “the implementation of a consistent legal code and ensuring its effective enforceability.” One of the considered options was a transfer of a part of the legal system—see BOX 59.

BOX 59 Legal system transfer

There were also opinions demanding that the legal norms or the entire legal system be transferred from another country. The transfer of entire legal norms was supposed to hasten the Czech transition to standard legal system. But the advocates of reforms argued that it was impossible. Jonáš pointed out the difference in informal institutions, which would prevent any such transfer (Jonáš 1999). Klaus also claimed that it was impossible to simply translate good laws, citing such reasons as the absence of necessary terminology, and the fact that foreign laws cannot be simply engrafted on another legal system (Klaus 1999). But his main objection was that many of Czech laws needed to involve the required transformation aspect. He claimed that the adoption of “nontransformation” legislation would lead to high transaction costs, probably unbearable for the society (he does not mention any specific examples, though). Using the example of East Germany, he shows the negatives related to the transfer of the West German legal system. Tříška argues similarly that all known attempts at the adoption of foreign legislation ended up in a catastrophe (Tříška 1999). He adds other arguments as well—not enough translators and that it was simply impossible due to political reasons to submit such laws to the Federal Parliament. The attorney Tomáš Sokol writes:

It is naive to imagine that it would have sufficed to translate the German Business Law, whose current version reflects the development of the business law and environment in the West Germany since the year 1945. We might have avoided the troubles with amendments, but in most cases the Czech business law progresses hand in hand with the business environment, and although the general principles are identical in all liberal states, the Czech law must reflect our current situation, and no translation from a foreign legal norm could guarantee this. Moreover, the problem of unclear interpretation would still exist in the same amount, and unifying practice of the courts would still be necessary. (*HN 2003 Yearbook 2003*)

Tříška writes that between 1990 and 1992, economic transformation was happening de facto in the environment of a legal vacuum (Tříška 2002). The assembling of the Business Law took almost two years, and it went into effect on January 1, 1992. Tříška also writes that there was almost no personal or ideological relation with the teams that prepared privatization, tax, or accounting laws, for example. There was not a single economist among the authors of the Business Code because the law was understood as legislative, not an economic document. According to Tříška, it did not take the needs of entrepreneurs and the economy into account; he claims the subsequent amendments made the situation even worse.¹³ He also notes that the struggle for the so-called minimum legislative corridor was successful—the so-called transformation law, with its highly flexible notion of the so-called privatization project, became its main component (Law no. 92/1991 Coll., on the transfer of state property to other persons); these laws came into force approximately a year before the Business Law. The transformation was based on the federal laws from 1990–92, and the entire legal system was based upon them as well. In 2004, Havel wrote:

No matter how some people emphasize that the Czech reform was based on shaky law, we may claim that in 1990–1992, as far as the formulation of legal standards and the formal quality of the decisions (especially of the federal government) are concerned, and with regard to modest objective options, a lot was undoubtedly done. ... It is hard to imagine that, concerning the creation of legal norms of the new type, this era could have been handled significantly better. (Havel 2004a)

The speed of passing new legislation in that period was fast and, as early as in 1993, Klaus was concerned about legal hypertrophy and about the fact that many new laws increased the power of the state (Klaus 1994).¹⁴ This was also very hard on the inhabitants, who had to constantly adapt to new legislation (Dyba and Švejnar 1997).

The tempo of passing the new legislation at the beginning of transformation was fast – for example the *Ekonom* published an article in 1994, claiming that almost 2,000 new regulations appeared within the last three years in the Collection of Laws—200 related to business, while the Commercial Code and the Trade Law were amended three times (Hříšník s diplomatkou přibývá

1994). Numerous new legislative measures were adopted in the ensuing period, too. The first important antimonopoly legislation was adopted in 1994 and the Law on Public Tenders was passed a year later (see Table 10.1).

Table 10.1: Number of adopted laws and constitutional laws in the CR, 1990–2004

Year	Number of laws in the collection	Year	Number of laws in the collection
1990	148	1998	47
1991	133	1999	72
1992	184	2000	152
1993	78	2001	104
1994	70	2002	139
1995	74	2003	99
1996	37	2004	153
1997	58		

Source: Automatizovaný systém právních informací.

Since the mid-1990s, some economists began to point to inferior legal environment, weak protection of ownership rights, and enforceability of law, which was in accordance with the general criticism of the institutional environment (Dobešová et al. 2003; Dědek 2000; Myant 2003). According to some, the quality of adopted legal norms deteriorated (Havel 1998). The government reacted with the second package of measures (stabilization and revitalization program) that involved institutional changes. But since the Klaus government fell in the fall of 1997, many of these measures were never implemented. A number of legal (and institutional) changes were executed by Tošovský's interim government in the first half of 1998. And the trend continued. One of the promises of the social democratic government in 1998 was the so-called legislative storm, planned to improve the inferior legal situation in the country. But Sokol documents that except for the year 2000, the parliament did not pass an exceptional number of laws, and so the term "legislative storm" is a little exaggerated (Sokol 2002). One of the priorities of the ČSSD election program was the preference for "new complex laws instead of permanent amendments," but the government did not succeed and the practice of amending continued, as we can see in the following table. Sokol observes that ordinary people had practically no chance to orient themselves in the ever changing legislation. As an excuse for the government and the parliament, I must say that numerous amendments had to be adopted to harmonize the Czech legislation with the EU.

Table 10.2: Number of changes in the main legal acts, 1992–2004

Law	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Commercial code	2	1	1	1	2	1	2	1	6	4	6	2	6
Civil code	1	-	1	2	2	1	2	2	4	3	5	1	5
Bankruptcy law	-	1	5	1	1	1	1	-	6	1	2	2	2
Trade law	2	2	4	2	3	6	4	5	16	8	6	8	8
Social welfare law	2	5	2	3	-	1	2	2	2	-	3	-	8
Income tax law	1	5	4	5	1	5	4	2	11	5	7	2	12

Source: Šedová (2005).

10.3.2 Criticism of the legal environment

There was a long-lasting discussion about the quality of the legal system in the country. Criticism of the legal environment was partially the criticism of the entire institutional environment—the authors who were critical about institutions in general were usually critical of the legal system as well. They criticized the underestimation of the role of law. Průcha mentions that:

Due to missing, unsuitable or delayed and insufficiently detailed legislation, the privatization took place in a chaotic legal environment, which hurt the Czech economy in the long run, made it easy to wash dirty money from illegal trading, imports and exports and the “tunneling” of property, it deformed the emerging capital market and subverted the confidence of foreign investors. Managers of state companies frequently tried to decrease the value of enterprises to be able to buy them cheaply. (Průcha 2000)

Others also criticize the legal frame, especially as related to the protection of ownership rights (Mlčoch 2000; Sojka 2000). Sojka wrote that “ten years after the beginning of transformation, ownership rights are not guaranteed yet” (Sojka 2000). He also mentions that although the liberal strategy was supposed to emphasize the legal frame, it did not. Sojka raises the question of whether it was due to incompetence or whether it was intentional (Sojka 2001).

Sommer and Tůma speak about insufficient supervision over the legal frame (Sommer and Tůma 1999). Havel joins in the deliberations about the role of law underestimation and writes that the reformers were for the rule

of law in general, but had no real notion of specific norms (Havel 1998). Besides, the criticism of the legal system was often related to privatization (see, e.g., Tošovský 2000).

On the contrary, Schwarz refuses the underestimation of the role of law on principle, writing that it is absurd to blame Klaus for legal nihilism (Schwarz 2003). He observes strong orientation toward public law and concurrent neglecting private law, which was in much worse condition after fifty years of totalitarian regime. He also refuses the general criticism of the liberal approach, which says that defined and effectively protected ownership rights are the condition *sine qua non* for the existence of the market economy (see also Ježek cited in Husák, 1997).

In addition to the general criticism of the legal environment, there was also partial criticism of the economists who supposedly “ran ahead” of lawyers and or that we should have adopted an entire foreign legal system. A critical attitude, according to which the economists during transformation “got ahead of the lawyers,” is advocated by Pick (2000). According to Klaus, this is one of the transformation myths, who claims that it was impossible for the economists to take over the law regardless of the lawyers, because most reforms were implemented through laws (and other acts similar to laws): “each and every liberalization, deregulation and privatization measure (was) implemented in the form of a law” (Klaus 1999). By contrast, Tomáš Ježek points to the problem with the lawyers. He claims that the lawyers, unlike to economists, were not prepared for the political change.¹⁵ He also points out the impossibility of separating the law from the economy (Ježek cited in Husák, 1997).¹⁶ Havel perceives the situation more complexly and claims that if the economists did not know anything about the creation of laws, the lawyers did not know anything about economy (Havel 1998).

The laws were not nor could have been perfect. If I compare the drawbacks in legislation and legislative activity, I must ask with Sojka whether the faults in the legislation were caused by ignorance, or whether it was intentional. This is a key issue for me, because mistakes were bound to happen. Klaus answers the question unambiguously:

The issue at hand is whether we failed because we did not ensure even more massive creation of new laws (or amending of the old ones) in the conflict-ridden, clumsy (because open) free, pluralistic society. My answer to this question is clear: no specific person failed. Fortunately, no authoritative

political system was created, which could, hypothetically, lead to a situation in which new laws could have been quickly “dictated” from the above by some wise men council (wise in the eyes of the authoritative ruler). Laws in our country were created and approved in the complex environment of kitsch moralizing, professional-group interests and ruthless political competition. I am speaking neither about considerable limits to our knowledge of legal theory, nor about similarly considerable limits to human understanding of complicated, multidimensional and ever changing reality. (Klaus 1999)

Češka agrees that there was no authority or person who knew how to avoid slowly but surely discovered errors in the legislation (Češka 2003). Still another reformer mentions that the gaps in the law were not part of some “dark conspiracy” (Ježek cited in Husák, 1997). He also says the laws were imperfect due to quick pace—the reform had to be quick to be successful, otherwise the opposition would obstruct it and there would be lobbyist pressures. The economy would descend into a “death valley,” where one system does not work anymore, while the other does not work yet. The reformers tried, says Ježek, to make this period as short as possible, because it was “lethally dangerous.” Tříška writes that “there was no more banal attack against the privatization in the early 1990s than to point to legislative unpreparedness for the steep growth of the private sector” (Tříška 2002). These attacks were hidden behind (seemingly noble) slogans about the fight against washing dirty money, conflict of interests, sale of the country to foreigners, and nomenclature of mafia conspiracy. Yet even the critics of the legal system (with a few exceptions, such as Mládek [2002]) did not claim that the shortcomings of the legal system were created by the government or the parliament intentionally, for example under the pressure from lobby groups. However, the above-mentioned light heating oils affair is worth mentioning in this context. It took several years to change the legislation and prevent the abusing of the light heating oils for tax avoidance. It seems to me suspicious because the problem was well-known for a long time. We could speculate that pressure groups that got high profits from this trade slowed down the amendment of the act in the parliament.

It is clear that the legislators were not prepared for the new political situation, just like everyone else, and I think Klaus is right especially about the parliament. There are no proofs to accuse anyone that the shortcomings

in the legislation were created or kept intentionally. A regular citizen can only hope that the drawbacks were not intended by the lawmakers.

I conclude this discussion with two quotes by the attorney Sokol:

After 10 years, the law system in the Czech Republic is right there where it can be with regard to our knowledge, legislative abilities and capacity of the government (and parliament) apparatus.... We have a justice, which (notwithstanding the excesses, a favorite food for the media) is not the top of the league, but the stories about its tragic condition are also exaggerated.

After ten—and it would be honest to say twelve years—we are at a stage, when the EU bodies consider our law to be compatible with the EU law and the performance of the justice sufficient to be admitted in the European Union. (*HN 2003 Yearbook 2003*)

10.3.3 Law enforceability: System of courts

In addition to the legal system proper, law enforceability turned out to be a serious issue. Many authors point out problems in this area (for example, Dědek 2000; Dillon and Wykoff 2002; Havel 2004; Kliková 2003; Mlčoch 2000; Pick 2000; Schwarz 1998). Table 10.3 testifies to the assertion that the law enforceability represented a real problem in the transformation process.

Table 10.3: Length of civil court proceedings in 1999

	Days
Business disputes	478
Labor disputes	582
Disputes according to civic code	371
Disputes according to family code	304
Apartment rent disputes	473
Ownership disputes	603
Restitution disputes	1,206

Source: *HN 2000 Yearbook* (2000).

One of the reform authors notes that even if a first-rate legal system were created, there was nobody to enforce it (Tříska 1999). The government and the entire state administration was undergoing personnel renewal.¹⁷ For the moment, the reform was weakening the state, because the bodies had to focus

on themselves rather than on their environment. This development was unavoidable if the bodies were to be purged of the proponents of the previous regime. Melecký claims that in the first half of the 1990s, the effort to purge the police, prosecutors, and courts—all labeled as the main henchmen of the previous regime—paralyzed the functioning of these bodies and created mistrust toward the apparatus, which compromised its positive functioning. As a result, the enforcement power of the state was severely weakened (Melecký 2003). The gravest mistake in the area of law was paralyzing the structures that enforce power; “the naïveté of this approach is unparalleled even after 1918, 1939, 1945, 1948, or 1968. In all these cases, the old professional apparatus was not replaced at all, or only when adequate replacements were found” (Havel 1998).¹⁸

I believe that most people wanted the state bodies to be purged of the proponents of the previous regime. Consequently, the capacity of courts to act plummeted, because thousands of new judges and prosecutors could not just emerge out of thin air. New lawyers were (and had to be) inexperienced and had to cope with constantly changing legislation. Other questions that came to the fore were: How would the old judges adapt to the new regime? And what was their willingness to support it? The number of court proceedings skyrocketed and the system was not prepared for it. These factors combined led to prolongation of court proceedings and consequently put ownership rights in doubt (Mlčoch 1997).¹⁹ This fact had a negative impact on the behavior of banks, who hesitated with bankruptcy requests.

It seems that the problem with law enforceability was unavoidable. Whether there were ways to make these problems shorter remains to be answered. But it appears to be rather a technical issue of the functioning of the judicial system, or its reform. I am not a lawyer and I do not dare to accuse the reformers of neglecting anything in the reform of the judicial system.

10.3.4 Measuring of the legal environment quality

In economic practice, we often come across the effort to quantify the legal environment in one way or another. The EBRD, in its Transition Reports, is one of the organizations that try to do so. The EBRD has two indicators—one relates to business law and it should measure to what extent a country reached

international standards. In addition to the overall index, the analysis also discriminates between extensiveness—that is the quality of a law; and effectiveness—that is implementation and enforcement of the law. The development of these indicators is shown in Table 10.4.

Table 10.4: Indicators of the business law in transitive countries, 1997–2002*

	1997			1998			1999			2000			2001			2002		
	Overall index	Extensiveness	Effectiveness	Overall index	Extensiveness	Effectiveness	Overall index	Extensiveness	Effectiveness	Overall index	Extensiveness	Effectiveness	Overall index	Extensiveness	Effectiveness	Overall index	Extensiveness	Effectiveness
CR	4	4	4	4	4	4	3	3+	3-	3+	3	3+	3	3	3	4-	4-	4-
Hungary	4	4	4	4	4	4	4-	4	4-	4-	4	4-	4-	4-	4-	4-	4-	4-
Poland	4	4+	4	4	4	4	3+	4	3	4-	4-	4	3+	4-	3	3+	3+	4-
Slovakia	3	3	3	2	3	2	3	3+	3	3	3	3	3+	3+	3+	3+	3	3+
Slovenia	3	4	3	3	3	3	4	4	4	4-	4	4-	4-	4-	4	3+	3+	4-

* The indicator aggregates three areas of law—securities, bankruptcy legislation, and common law; the index assumes values from 1 to 4+ (the highest value indicates environment on a par with advanced countries). The overall index is the mean value of extensiveness and effectiveness. For more on the index see EBRD.

Source: Transition report (2000, 2002).

From the index presented in the table it seems that the business law in 1997 and 1998 (i.e., the period of massive criticism of the legal environment) was almost at its highest possible level and was fully comparable with other transforming countries. Yet it was much worse in the second index presented in the table—capturing financial regulations and overall legal frame in banking and financial institutions—was much worse (see Židek 2004). Nothing indicates that the legal situation around 1997 was exceptionally bad. But in 1999, the legal environment worsened mysteriously (in my opinion), and it collides with the effort of the social democratic government to improve the legal situation.

Another institution that measures the overall legal situation is the Freedom House. Its index involves assessment of the constitutional, legislative and judicial systems, with the emphasis on constitutional reforms, protection of human rights, reforms of the criminal code, independence of courts, and the statute of ethnical minorities. From an economic viewpoint, this index is not

of much interest. Like with the EBRD, in the Freedom House index we may also observe sharp, sudden, and in my opinion hard to explain deterioration of results in 1999—see Table 10.5.

Table 10.5: Constitutional, legislative, and judicial systems in the CR and Hungary, 1997–2003 according to the Freedom House

	1997	1998	1999	2001	2002	2003	2004
CR	1.50	1.50	2.25	2.50	2.50	2.50	2.50
Hungary	1.75	1.75	1.75	2.00	2.00	1.75	1.75

The index assumes values between 1 and 7, where 1 is the best system and 7 the worst.

The index is compiled on the basis of "the consensus among the Freedom House, academic advisors and authors of the report."

Source: Freedom House (2005).

What do these indexes reveal? The fundamental conclusion is that the Czech legal environment was no different from the situation in other transforming countries. The sharp index worsening in 1999 is another issue. I do not believe that the legal system in the CR worsened dramatically in 1999. My opinion is that the authors of the analyses succumbed to the widespread perception of the legal system, characteristic for the era of economic recession. If the worsening of indexes was the expression of a certain correction, it casts a serious doubt on all other quoted values.

10.4 Bankruptcy law

The economic nature of bankruptcy lies in the possibility of resource relocation—if an enterprise declares losses and goes bankrupt, those who acquire the property assume that they can use the assets more effectively—for definition see BOX 60. Therefore it is in essence a process of cleaning market structures from economically ineffective entities. The process—referred to as creative destruction by Joseph Schumpeter—is permanent, but it gains momentum during an economic recession. Conversely, bankruptcies give the creditors a chance to assert their rights. The faster the bankruptcy process, the more assets the creditors save, and the earlier it will be used more effectively (Simonson 2000). If bankruptcies do not occur, a loss-making company probably increases its obligations and the problem aggravates. The bankruptcy process plays a key role for the health of the economy in both

standard and transforming economies. Slow bankruptcies in the CR had negative impacts in other areas—especially in the banking sector and the restructuring of enterprises.

BOX 60 Definition of bankruptcy

.....
Legal definition of bankruptcy is to be found in the Law No. 328/1991 Coll., on bankruptcy, which says in § 1 that:

(1) The purpose of this law is to settle property conditions of the debtor in bankruptcy.

(2) The debtor in bankruptcy has several creditors and is unable to pay his obligations for a long time. If the debtor ceases to pay, it is assumed that he is unable to meet his payment obligations for longer time.

(3) Physical person (entrepreneur) and/or legal person is bankrupt if it is in heavy indebtedness. A person is in heavy indebtedness if it has several creditors and its payment obligations are higher than its property; the evaluation of the debtor's property will also involve planned revenues from continuing business activity, if an income exceeding expenses in case of continuing business activity can be justly expected.

Bankruptcy thus occurs in two situations:

- a) in case of insolvency (§1 article 2), that is inability to pay due obligations.
 - b) in case of heavy indebtedness (§1 article 3), that is when due obligations are higher than the debtor's property.
-

In the early 1990s, a high percentage of Czechoslovak enterprises were on the verge of an economic collapse. Tříska mentions that an analysis in 1990 claimed that 80 percent of Czechoslovak enterprises was “technically” bankrupt, that is in a situation in which no rationally calculating bank would lend these companies a single dollar for a single day (Tříska 2002). The number is very high, and perhaps exaggerated. But it is clear that many Czechoslovak companies would not survive in a “normal” economy. However, the number of bankruptcies did not indicate such state (see Table 10.6).

During transformation, the bankruptcy law came to the forefront several times. First, in the very beginning, in relation to the fears of sharply increasing unemployment due to mass bankruptcies. Second, when slow bankruptcies were presented as proof of slow restructuring. Next, when it related to the linkage between banks and enterprises after privatization.

Finally, in the context of the post 1997 crisis and the generally bad institutional environment.

Table 10.6: Bankruptcies, 1992–2002²⁰

	Filed bankruptcies	Total unsettled cases*
1992	1	234
1993	66	929
1994	294	1,864
1995	727	3,179
1996	808	4,575
1997	1 251	6,027
1998	2 022	8,087
1999	2 000	9,706
2000	2 491	10,500
2001	2 473	—
2002	2 155	—
2003	1 728	—
2004	1 411	—

*unsettled cases are the ones where the bankruptcy proceedings were not started yet, and the cases in which bankruptcy was already declared, but the proceedings have not finished yet.

Sources: Matocha (2003); Junek, Lucová, and Šperková (2009).

Bankruptcy legislation was criticized since the very beginning of the transformation (e.g., Frydman et al. 1993). Moreover, for the enterprises waiting for privatization, the law did not come into force before 1993. Fawn writes that Klaus and Ježek spoke in favor of bankruptcies for loss-making companies in the beginning of transformation, and they even put more emphasis on this element than on the emerging of new companies, but in reality, the psychological barrier of high unemployment had the upper hand (Fawn 2000). Consequently, the law was modified and adopted in a milder form, which gave only a slight chance to initialize bankruptcies, especially for small creditors as the banks had better leverages, but did not use them much (Desai and Pistor 1997). Simonson discusses the law that the creditors were in essence prevented from initializing bankruptcies, for example by the provision that such measure could take only a court-appointed officer (Simonson 2000). Those who had securities were not allowed to act independently and had to wait for a decision of an administrator in bankruptcy. The main reason for the cautious approach to bankruptcies was, in addition to disturbing the privatization process, the fear of the so-called domino effect (Janáček and

Klvačová 1994), where one bankrupt company might, due to mutual links, draw other companies into the abyss. The ensuing discussions resulted in the law that stood on the side of the debtor. Čermák is convinced that the government did not want the companies to go bankrupt (Čermák 2000).²¹ Desai and Pistor juxtaposed the double delaying of the law in Czechoslovakia with the situation in Hungary, where ninety days after the law came into force 3,500 companies went bankrupt (Desai and Pistor 1997). The setting of the law was just one side of the coin, the other was its enforceability in the judicial system. Janáček and Klvačová pointed to this fact as early as in 1994, when they wrote that there were ten times more filed bankruptcies than declared bankruptcies (Janáček and Klvačová 1994). The problem was the pace of court decision making, as documented in Table 10.6. However, Klaus disagrees:

I do not think that an early wave of bankruptcies would have been a purging process.... "Purge" is possible if the goal is to recover ill enterprises. If the goal is to transform the entire economy, I do not quite understand the term "bankruptcy purge." (Klaus 2000a)

The Hungarian approach in my view clearly shows that the economy did not collapse with the wave of bankruptcies. Higher level of bankruptcies at the beginning of the transformation process would have cleaned the economic environment.

The second round of interest in bankruptcies emerged with restructuring. Slow bankruptcies were perceived by some economists as proof of the slow restructuring of the corporate sector (for example, Simonson 2000). Similarly, Jonáš wrote that the nonexistence of bankruptcies caused the survival of ineffective companies (Jonáš 1997). Myant uses the example of Poldi Kladno about how long and complicated the bankruptcy proceedings in the CR were; moreover, he claims the entire process revealed the incompetence of bureaucrats (Myant 2003). Holman explained the lower number of bankruptcies by the existence of transformation cushions (Holman 2000). Bankruptcy cannot be perceived, he says, as a restructuring tool, but only as a preventive measure, because bankruptcies are very expensive for all subjects involved.

Bankruptcies came to the forefront again after the voucher privatization, when the banks kept alive numerous subjects that should have gone bankrupt a long time ago (Havel 2004). The resulting relation between the banks, in-

vestment funds and companies was considered to be the reason for the banks unwillingness to declare their debtors bankrupt. The reasoning was that if the bank declared the enterprise bankrupt, its own fund would lose assets. Other authors saw the reasons why the banks did not file their debtors for bankruptcy, and even lent them more money. One explanation might be that the banks were state-owned, and did not initialize bankruptcies to keep the unemployment low (Simonson 2000). Dillon and Wykoff also pointed to the intertwined relation between the banks and state-owned enterprises (Dillon and Wykoff 2002). Čermák indicates that the banks kept providing loans, because the bankruptcy proceeding was long, as well as the selling of securities (Čermák 2000; for more on problems with securities, see Simonson 2000). The market value of securities was much lower than the debts.²² The fact that bankruptcies were not filed against large corporate clients due to hesitation of large banks was mentioned in the OECD report (*Ekonom* 1994b; Jak nás vidí OECD 1994). Holman also wrote that there were few bankruptcies due to the banks' behavior (Holman 2000). The first large company that went bankrupt was Poldi Kladno in 1998, followed by Chemapol in 1999.

The bankruptcy legislation was referred to as a source of problems in the frame of the overall criticism of the institutional environment after the monetary crisis 1997 (for more on this, see BOX 36).

The bankruptcy law was amended on numerous occasions—twenty-three times between 1993 and 2004, with thirteen times after 2000 alone. Requisites for proposal filing were specified, as well as rights and obligations of the bankruptcy administrator. It seems from the total number of amendments that every new amendment was immediately mature for a new amendment. Simonson also mentions errors in the bankruptcy laws (Simonson 2000). Mládek claims that inferior bankruptcy law amendments were pushed through by pressure groups (Mládek 2002). He opines that privatization generated nouveau riche capitalists who liked their positions and did not want to lose it. This is why they put up much effort to eliminate the threat of losing their company, that is the threat of bankruptcy. Mládek claims it was easier to lobby in the parliament against an effective bankruptcy law than to compete on the international markets (Mládek 2002).

Data from the World Bank database Doing Business (www.doingbusiness.org) also document the fact that bankruptcies were in 2003 still a serious problem in the Czech Republic. The section about closing a business contains data that illustrate the Czech situation (see Table 10.7).

Table 10.7: The World Bank Group: Closing a business (January 2003)

	Length of proceedings (in years)	Real expenses (% of property)	Process goal (index)	Court power index
CR	9.2	38	22	0
Hungary	2	38	38	33
Poland	1.5	18	70	67
Slovakia	4.8	18	71	67
Slovenia	3.7	18	41	67
Europe and Central Asia	3.2	15	51	57
OECD	1.8	7	77	36

Length of proceedings—lawyers' estimation of the time required for finishing the procedure; real expenses—expenses paid for settling the case in court; process goal (index)—provides complex survey (100 the most effective); court power index—a degree to which courts carry out bankruptcy proceedings (higher numbers – higher participation).

Source: The World Bank Group (2003).

I may state with Mlčoch that the government policy regarding bankruptcies was initially very cautious (Mlčoch 2000). On the contrary, even the critics of bankruptcy legislation admit that tougher bankruptcies would probably have catastrophic economic impact due to debt chaining (e.g., Myant 2003). I must add that ignorance and lack of experience also related to bankruptcies, which did not exist under socialism. This is why it should not be surprising that administrators were inexperienced, and there were also those who were able to seize the opportunity for their own enrichment (e.g., the judge Berka²³ affair).

It is obvious that the government had to look for an optimum measure of bankruptcies since the beginning of transformation—a compromise—on the one side, to not let 80 percent of the economy go bankrupt (Tříska 2002) and, on the other side, to purge the environment from ineffective enterprises. The number of bankruptcies in the initial phases of transformation (66 in 1993 and 294 in 1994) and the length of the entire process prove that something was not right. In my opinion, the chosen compromise was ineffective with laws set in favor of the debtor, and the number of bankruptcies should have been much higher, namely in the years of economic growth (1994–96) when the economy would withstand the pressure and the economic environment would have been purged. The result was that the government preserved unemployment low, but the problem spread to the banking sector and unemployment increased anyway.

10.5 Corruption

Corruption has always been and still is an existing phenomenon in the Czech environment.²⁴ It is certainly neither new nor exceptional—let us once again remind the reader of the situation at the end of the 1980s when bribing was a common practice. We may say that at the beginning of the transformation, corruption was a firmly anchored informal institution. I can mention a survey that said that as much as 52 percent of Czechoslovak population in 1989 admitted giving a bribe the previous year (Fassmann 2007).

The phenomenon of corruption is hard to capture. It is quite interesting that corruption did not become a widely discussed topic until the end of the 1990s (for example, Orenstein 2001). The anticorruption policy became one of the priorities of the social democratic government after the 1998 elections. The cabinet adopted the Government Program of Struggle Against Corruption in February of the following year.

Table 10.8: Transparency International Corruption Perception Index, and the position of the country, 1995–2004

	1995	1996	1997	1998	1999
CR	-	5.37(25)	5.20(27)	4.8(37)	4.6(39)
Hungary	4.12(28)	4.86(31)	5.18(28)	5(33)	5.2(31)
Poland	-	5.57(24)	5.08(29)	4.6 (39)	4.2 (44)
Slovakia	-	-	-	3.9 (47)	3.7 (53)
Slovenia	-	-	-	-	6.0 (25)
best	New Zealand	New Zealand	Denmark	Denmark	Denmark
(index value)	(9.55)	(9.43)	(9.94)	(10)	(10)
No. of countries	41	54	52	85	99
Used sources*	7	10	7	12	17
	2000	2001	2002	2003	2004
CR	4.3(42)	3.9(47)	3.7(52)	3.9(54)	4.2 (51)
Hungary	5.2(32)	5.3(31)	4.9(33)	4.8(40)	4.8 (42)
Poland	4.1 (43)	4.1 (44)	4.0 (45)	3.6 (64)	3.5 (67)
Slovakia	3.5 (52)	3.7 (51)	3.7 (52)	3.7 (59)	4.0 (57)
Slovenia	5.5 (28)	5.2 (34)	6.0 (27)	5.9 (29)	6.0 (31)
best	Finland	Finland	Finland	Finland	Finland
(index value)	(10)	(9.9)	(9.7)	(9.7)	(9.7)
No. of countries	90	91	102	133	146
Used sources*	16	14	15	17	18

*number of used statistical sources; data about the CR were usually contained in approximately two-thirds of these statistics.

Source: Transparency International (1995–2004).

The Czech Republic ranks low in most indexes that capture the phenomenon of corruption. To quote a worldwide statistics that attempts to cover the issue in a more complex way, I use the Corruption Perception Index of the Transparency International (TI) organization (see Table 10.8).²⁵

There are many surprising aspects about the development of this index in the CR,²⁶ just like in some other indexes that became mysteriously worse after 1997. I must ask again whether corruption really increased as much in this period as shown by the TI? The index compilation system explains a lot—it is basically an aggregation of results of other statistics. Many of these partial statistics are based on such formulations as: “Do you consider the corruption in your branch to be high (7) or mild (1)?” An example of this type of formulation is in Table 10.9.

Table 10.9: Nonstandard payments in relation to loan applications

	CR	Hun.	Pol.	SR	Sloven	Austr.	France	leader	Average
Question 6.25 How would you estimate the current rate of officially unrecorded extra payments or bribes related to loan applications in your branch? (1 = normal, 7 = never)	4.5 (78)	5.2 (50)	4.6 (75)	5.3 (48)	5.6 (36)	6.5 (10)	6.3 (18)	New Zeal. (6.8)	5.2

Source: World Economic Forum (2004).

According to this statistic, it is fairly normal to bribe while getting a loan—the index is even worse than the average value of all 104 quoted countries. The banks have stable foreign owners (Austria and France are quoted for the purpose of comparison), the process of loan awarding is standard (several degrees), and the banks are making profit. For these reasons, I have certain doubts about these results. I think it is very likely that unsuccessful loan applicants simply say that it is impossible to get a loan without corruption. Another explanation is the overall mood in the country. The conviction is that corruption is omnipresent and therefore it must be present in this area as well.

The Business Environment and Enterprise Performance Survey provides an entirely different result (Fries, Lysenko, and Polanec 2003). Its authors polled companies and estimated the so-called bribe tax, defined as “unofficial payments to public officials.” The results are different from the aforementioned statistics—see Table 10.10.

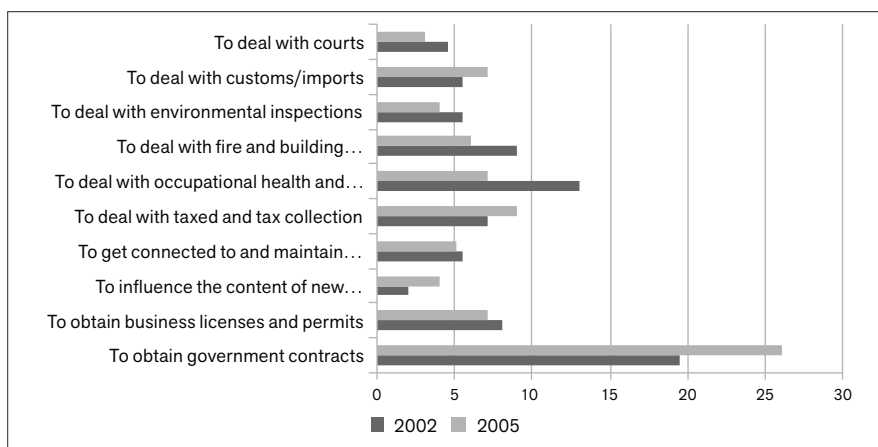
Table 10.10: Frequency and scope of the “bribe tax”

	Percentage of companies that bribe		Average “bribe tax” as a percentage of annual corporate revenues	
	1999	2002	1999	2002
CR	26%	13.3%	1.7%	0.9
Hungary	32.3%	22.6%	0.9%	1%
Poland	33.2%	18.6%	0.7%	1.2%
Slovakia	33.6%	36%	1.3%	1.4%
Slovenia	7.7%	7.1%	1.4%	0.8%
Average value of all countries in the poll			1.9%	1.6%

Source: Fries, Lysenko, and Polanec (2003).

The results show that the situation in the CR was not ideal, but better than in most post-socialist countries, except for Slovenia. The development of the index is the opposite of the TI index—between 1999 and 2002, both values improved substantially. I think the difference is in the wording of the poll query. In this case, the authors asked “What bribes does your company give?” and not “What is, in your opinion, the amount that companies in your branch give?” (see Figure 10.1).

Figure 10.1: Percentage of firms claiming bribery is frequent



Source: World Bank: Beeps at Glance: 2006

I am far from belittling the issue of corruption. It certainly does exist in the Czech society (and it is not surprising if we remember the functioning of the

centrally planned system)—the question is its rate.²⁷ The aforementioned facts leave doubts whether the habitually quoted rate of corruption—especially the TI Index—has anything to do with reality. I feel the Index rather reflects the overall feelings of the respondents. The feeling is based especially on expectations regarding administration of state contracts. Meanwhile corruption on micro level (on the level of ordinary inhabitants) faded in my view. For example in 1999, 74 percent of people said that they never give bribes (GFK, 27. 5. 2006). Ordinary people usually do not need to offer bribes but they feel with high discomfort that decisions in high politics especially about government contracts are made under grafts influence. More on this issue in for instance Volejníková (2003), on partial indexes capturing the phenomenon of corruption in for example Židek (2004) and on anti-corruption measures in Steves and Rousso (2003) as a good example.

10.6 Market environment: economic freedom

Another feature of institutional setting is the quality of market environment, which I equate here with economic freedom. According to some authors, the economic freedom correlates strongly with the per capita GDP, economic growth and even with anticipated lifespan (for example, Gwartney, Lawson, and Emerick, 2003). I believe that economic freedom relates to the effectiveness of the entire system. If obstacles were created on the market (for any reasons), it would have negative side effects on the entire system's effectiveness.

If legal environment is difficult to assess, assessment of the market functioning is similarly hard. The state of the market environment consists of various characteristics—price liberalization, corporate administrative expenses, labor market regulations, protectionist measures in foreign trade, and so on (you can see that the market environment is closely intertwined with the legal environment).

In the beginning of the transformation period, the strong deregulation effort of the government was clearly apparent. Let us mention price liberalization, effort to limit the role of the state in the economy, lowering taxes, liberalization of foreign trade and the overall effort to deregulate the economy. But let us not forget that price liberalization remained unfinished, the role of the state was limited only partially, and the taxes remained relatively high. Nevertheless, in the mid-1990s, the Czech economy was the most liberalized

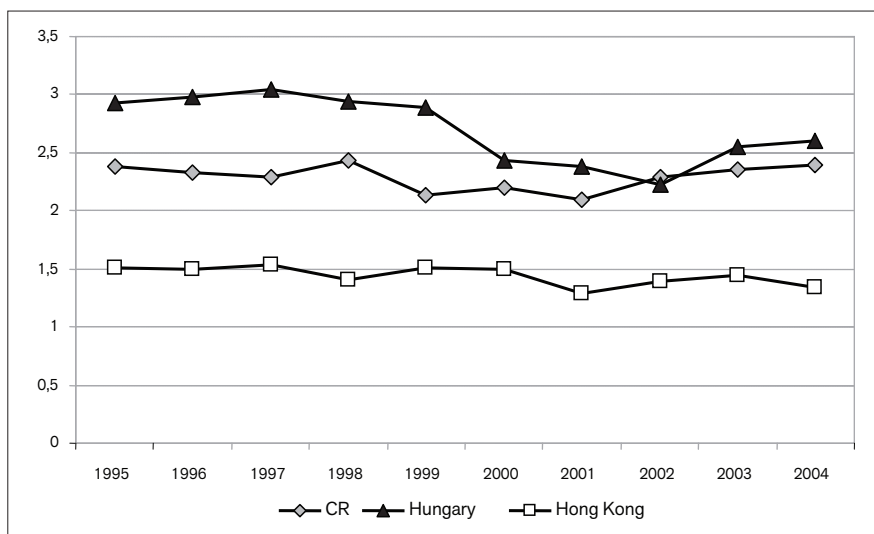
of all emerging markets (Dillon and Wykoff 2002). But it was in this period that the market environment became a target of criticism, together with the institutional environment as a whole.²⁸ Schwarz perceives the regulation of economic environment as the main problem of the Czech economy in this period (Schwarz 2003). He coins the term “bazaar capitalism”—a system in which economic subjects are burdened with high transaction costs, which leads to the preference of short term goals at the expense of long term goals. Schwarz also observes that “the incredible tolerance of the state to the breaking of voluntary contractual obligations was supposed to replace the ever more frequent and detailed regulations and restrictions of all subjects”; he also notes that the increasing role of the state in the society creates a corruption-friendly environment (Schwarz 2003). Similarly Klaus writes that those who complain about neglected legal frame of the transformation, long for stronger regulation (Klaus 2000a).

Tríska joins in with his criticism, pointing out the business law amendment of June 1996, for instance (Tríska 1999). He writes that under the pretext of protection of small shareholders, the already inconsistent law was so fundamentally itemized that it led to higher business expenses, especially for the starting entrepreneurs. He says that someone should have made a joke that after this legal norm was passed, the queues in front of business registries tripled and bribes increased ten times. He also notes that the law was not passed by a left wing government, but by the right-wing coalition.

Two institutions developed indexes to measure economic freedom—the Heritage Foundation and the Frazer Institute. The former publishes the annual Index of Economic Freedom. Its authors define economic freedom, which they loosely translated as “the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself.” (Feulner and O’Grady 2004). The index has ten categories, the data are gathered from other polls (for example from Transparency International on the informal sector; see Figure 10.2).

Two facts can be observed in the graph. The CR is considerably lagging behind the leader (Hong Kong); the economy was definitely not too liberal even when the right-wing coalition was in power, and, the situation did not change when the social democrats took power in 1998 either. Problems of the CR with economic freedom (according to Feulner and O’Grady 2004) are summed up in Table 10.11.

Figure 10.2: Index of Economic Freedom, 1995–2004



Hong Kong led the ratings all the time.

1 – the freest country, 5 – the most economically suppressed countries

Source: Heritage Foundation (2004).

Table 10.11: Index of Economic Freedom in 2003 for the CR, Hungary, and Hong Kong

	CR	Hungary	Hong Kong
Total score	2.39	2.6	1.51
Ranked	32	42	1
Group:	Predominantly free	Predominantly free	Free
Business policy	3	3	1
Fiscal burden	3.9	3	1.9
Government intervention in the economy	2.5	2	2
Currency policy	1	3	1
Foreign investments	2	2	1
Banking and finance	1	2	1
Wages and prices	2	3	2
Property rights	2	2	1
Regulations	3	3	1
Informal sector	3.5	3	1.5

Individual indexes assume values from 1 to 5; 1 stands for the environment closest to economic freedom.

The data were gathered in the second half of 2002 and the first half of 2003.

Individual categories are more detailed and the analysis is thus quite complex.

Source: Heritage Foundation (2004).

Another complex index is published by the Frazer Institute in the Economic Freedom of the World study (Gwartney, Lawson, and Emerick 2003). The index is compiled of partial indexes and uses for example data from the Global Competitiveness Report (Table 10.12).

According to the Fraser Institute, economic freedom in the CR has not increased since 1995. The CR was ranked forty-fifth and the gap behind the leader was quite considerable, especially in the figures of the government (1) and state regulations (5).

In professional press, I may find individual partial statistics for this area (see, for example, Židek 2004). One example is operations required to start a business—according to Doing Business research of the World Bank—which is, in my view, symptomatic of the Czech economic environment. Table 10.13 shows high expenses for people and companies that wanted to start a business in the CR. The CR was unfortunately in line with the other countries in the region—some statistics were worse, some slightly better. Australia gave a good example of how to eliminate expenses on launching a business.

Table 10.12: Economic freedom in the CR, Hungary, and Hong Kong

	CR*			Hungary		Hong Kong	
	1995	2000	2004	1990	1995	2004	2004
total rating (ranked)	5.8 (68)	6.8 (43)	6.9 (45)	5.0 (74)	6.3 (46)	7.4 (20)	8.7 (1)
1. size of government	3.1	4.6	4.4	2.9	4.7	5.3	9.1
2. legal system and protection of ownership rights	6.5	6.9	6.6	7.2	7.6	6.4	7.5
3. access to sound money	6.0	9.2	9.0	5.6	6.0	9.5	9.2
4. freedom of change with foreigners	7.8	7.8	8.3	4.8	7.0	8.3	9.5
5. loan, labor and business regulation	5.4	5.7	6.4	4.6	6.0	7.3	8.3

* data for the CR in 1990 were not quoted.

The scale has 10 points the higher the value, the higher the economic freedom.

Each of the five categories is further itemized and the points are given to individual sub-categories as well.

Source: Gwartney, Lawson, and Emerick (2006).

Table 10.13: Starting a business according to Doing Business—World Bank (January 2003)

Economy	Procedures (number)	Time (days)	Cost (% of income per capita)	Minimum capital (% of income per capita)
CR	10	88	11.7	110.0
Hungary	5	65	64.3	220.3
Poland	12	31	20.3	21.4
Slovakia	10	98	10.2	111.8
Slovenia	10	61	15.5	89.1
Australia	2	2	2	0
Europe & central Asia	10	47	21.7	114.0
OECD: high income countries	7	30	10.2	61.2

Source: The World Bank Group (2005).

In this chapter, I analyzed the development of institutions during the transformation. I believe that institutions in a broader view are crucial for a long-term economic development. Some aspects of the institutional environment developed turbulently, for example the legal system. The progress of other (namely informal) institutions stagnates and negative aspects from the totalitarian period survive, for example corruption. I agree with the first part of the following consideration. Havel mentions all negatives of the institutional environment, including inferior laws, poor enforceability of law, poor legal awareness, and so on (Havel 2004). He also writes that no institutional almighty God could have created the institutional environment in advance: “it is simply an illusion.” Institutions, says Havel, emerge and develop by being used, through the mechanism of mutual reaction with reality, and it takes decades or even generations to build them. However, he says, these facts are no excuse, because we did not do everything we could have done.

It is true that there is always a possibility to do more. But in my view, many critics somehow forgot about the main aspect of the institutional development—path dependency. This is the core idea of the institutional way of thinking. They would like to create perfect environment and society and expect that the government should be held responsible for it. There is for example a ridiculous view that privatization should be implemented only after the creation of a perfect legal environment. I am quite sure that the very same authors would not deem our contemporary legal environment good enough for privatization. It means that privatization would have been postponed (probably indefinitely). The path dependency appears the strongest

way in informal institutions, for example in corruption. We can hardly expect perfect and clean society when in 1989 half of the population admitted giving bribes. We cannot expect that as a result of a political change people start to behave an ideal way similarly to countries with a long tradition of clean behaving—for example Scandinavian countries; the government influence over informal institutions is dubious.

After a thorough analysis of the transformation development in the Czech economy I provide the readers with a comparison of the transformation development in two other central European countries—Hungary and Poland.

Notes

- ¹ In my view, it did not only apply to the economic sphere.
- ² These alternatives primarily relate to formal institutions.
- ³ Disputes over the impact of institutional factors on the economy intensified in the period of economic crisis after 1997 (see BOX 36).
- ⁴ On the familiarity with the Austrian school, see for example Klaus, who writes: “The Austrian school and its importance for transformation processes in contemporary world” (Klaus 1995c). It is true, though, that the author does not explicitly mention institutions or law in the article. Besides, Myant says that Hayek claims that the market environment develops autonomously, which led the reformers to believe that institutions did not have to be created (Myant 2003).
- ⁵ Stanley Fischer was the number two man in the IMF early in the 1990s.
- ⁶ Although the CR had standard institutions (for example capital markets), they did not function in a standard way (Mlčoch 2000).
- ⁷ Havel disagrees with this opinion: “it is not true that there are no legal tools to punish the tunneling of banks, funds or industrial enterprises. We have many such tools, but we are lazy, unwilling or unqualified to use them” (Havel 1998).
- ⁸ It is hardly imaginable that the judges would have been allowed to interpret the law at their own discretion. I do not think that the inhabitants would prefer society where the judges could decide arbitrarily and different ways in individual cases.
- ⁹ Ivo Svoboda, the finance minister in the social democratic government of Miloš Zeman, ended up in jail for tunneling of company Liberta.
- ¹⁰ An aside note to complement this point: in my college classes, I present my students the following dilemma: “You can take out the assets from your company (let us say 2 billion CZK) and use it to live in comfort on the Bahamas until the end of your life. Your actions will be fully in accordance with the law, but some people will perceive it as immoral. Which of you is sure that you would not do it?” These are university students, the future elite of the nation. The result is that approximately 10 percent of the students raise their hands. Of course, the value of such poll is limited and I do not know what the students would really do if they really could. The herd effect may also play its role, the question is suggestive, and so on; however, the result is still very interesting. My somewhat exaggerated conclusion is that ordinary people are often angry because they did not get the chance to participate on tunneling.
- ¹¹ The basis of the LTO affair was that a substance declared as the LTO (light heating oil) was not burdened with the excise tax and the value-added tax was only 5 percent. Diesel oil declared as the LTO was 10 CZK per liter cheaper than the real diesel. It is estimated that the state thus lost 60 to 100 billion CZK in tax revenues, and two dozen murders are also linked to the affair (Blažek 2004). Vít mentions

the following startling fact: “In the very beginning of the entire affair, the Slovak parliament (in a night session) ensured a remedy—all they had to do was to unify the tax and dye the diesel oil. The Czech government politicians quarreled about available options for three years” (Vít 2004).

- ¹² Although the formal level of the Czech law was supposed to be better than in other socialist countries (Havel 1998).
- ¹³ Havel perceives this norm as admirable with regard to limited time and conditions under which it was created (Havel 1998).
- ¹⁴ Conversely, Klaus wrote as early as in 1994 that “in a record-breaking time, we managed to create the needed legal frame for the market economy, a functioning banking sector” (Klaus 1994).
- ¹⁵ According to the author, economists in the previous regime were privileged, because communist leaders expected them to provide a miraculous formula for economic improvement.
- ¹⁶ Havel blames Ježek for inferior legislation on the capital market (Havel 1998).
- ¹⁷ For many weeks, the Czech government was given every Wednesday a list of 100 judges and had to decide which of them could continue (Pithart 2005).
- ¹⁸ In my view, this statement is almost impossible to defend, although I do not have numbers. It is well-known that after the World War II, there was a massive hunt for all real (and sometimes alleged) collaborators. The Communist Party was putting its people in power enforcement bodies since 1945. The condition of Czech justice in the era of monster processes “with the enemies of the socialist regime” in the early 1950s is clear from any document from the era.
- ¹⁹ In local courts in Prague, it is considered to be a success if the court begins to deal with the case within one year from the lawsuit filing (Havel 1998).
- ²⁰ Information about the number of companies under bankruptcy proceedings is not usually available; the ČSÚ is not obliged to provide this information.
- ²¹ The government used other measures to avoid a wave of bankruptcies, and therefore it introduced the option to solve disputes by extra-judicial measures and mutual inclusions (Janáček and Klvačová 1994).
- ²² One of the reasons was that securities were frequently overvalued.
- ²³ The judge Jiří Berka was accused of manipulating bankruptcy proceedings and declaring companies bankrupt unjustly. The afflicted companies were plundered by bankruptcy administrators who collaborated with Berka.
- ²⁴ The very definition of corruption is problematic (e.g., Lopourová 2004).
- ²⁵ I should emphasise that the index measures “perception” and not “corruption” as itself.
- ²⁶ Problems that arise from the index compilation method are discussed by Pachmann (2005).

- ²⁷ Let us note that advanced economies also have similar problems with corruption; for example the *Economist* reported on September 7, 2005 the Volkswagen affair, where top corporate executives were corrupted.
- ²⁸ I have already pointed out these opinions in BOX 26 about the unfinished transformation, or rather the decelerated transformation effort.

TRANSFORMATION IN HUNGARY

This chapter analyzes the transformation process in Hungary. I will start by describing the long-term political development in Hungary, which had an impact on the state of the Hungarian economy at the end of the 1980s. Then I concentrate on the political development during the transformation era that I consider as the period between 1990 and 2004. In the rest of the chapter I concentrate on the most important aspects of economic policy, privatization and economic results.

11.1 Long-term political development

Hungary's long-term economic development has deep roots. The key event was World War I and its aftermath. Hungary lost an important part of its land possession to successor states of the Austro-Hungarian empire. Large Hungarian minorities appeared in the neighboring countries—Czechoslovakia, Romania, and Yugoslavia. It was deemed by Hungarians as totally unjust. The main goal of Hungarian diplomacy in the interwar period was unifying all Hungarians into a single state or in other words to recreate large Hungary. The way to achieve this goal was in cooperation with fascist Germany in the 1930s, and Hungary became German's ally during World War II.

Consequently, we can hardly talk about “liberation” of Hungary by the Red Army at the end of World War II. Hungary fell into the zone of the Soviet influence, and the communists (Hungarian Workers' Party) were able to establish a soviet style regime in 1949. But Hungarians were among the first that with force stood up against their regime during the 1956 riots. This uprising was bloodily suppressed by the Soviet troops. But even the communist establishment understood that an important part of the Hungarian society disliked

the regime. János Kádár (1912–1989) became the leader of the collaborationist government after the uprising. His government first harshly suppressed its opponents but in the 1960s started to relax political and economic environment. His regime is sometimes referred to as “goulash communism” (Kornai 1996). This term means situation when people are generally willing to accept the regime in exchange for more open economy (e.g., foreign goods), higher consumption, and more freedom. This trend is clearly visible in the economic policy or reforms that were approved after 1968.

Political relaxing deepened during Kádár’s period and led even to the formation of an opposition in the mid-1980s. Round table negotiations with the opposition took place in 1989. They resulted in the change of the constitution that guaranteed transition to democracy, market economy, human rights, and explicit ban of a single party government (even in the situation when the party had majority in the parliament). This change was approved on October 23, 1989 and it is considered to mark the beginning of a new democratic Hungary. The country “jumped” this way directly into democracy with free elections in March 1990. Hungarians avoided any form of pseudo-democracy or government of national unity.

11.2 Economic situation and development before 1989

Political development had outright impact on the development of the Hungarian economy. The centrally planned system was established in the country after World War II. There were of course differences with other centrally planned systems in the region but the basis of the system was similar. Hungarian’s system was generally not as tough as in Czechoslovakia but even bigger differences started to appear with their reforms after 1968.

The core of the reforms (named New Economic Mechanism) was in decentralization of the decision-making process in the economy that was shifted from the center to the companies. But the main decisions (for example about investment or armament industry) were still made by the government, although companies were relatively independent, in contrast to their counterparts in Czechoslovakia.

The central government regulated prices, wages, and interest rates but in the course of time more responsibility was shifted to the companies. And there were many more striking differences. In the 1980s, foreign direct

investment was allowed and joint-ventures with western companies appeared. Already in 1989, Hungary lured the first car producer, Suzuki and also Tungsram was purchased by GE Lighting Europe.

Hungary unified its exchange rate as early as in 1981.¹ And following 1988 all enterprises were allowed to pursue international trade in convertible currencies after gaining a virtually automatic registration with the Ministry of Trade (Medvec and Stone 1990). Hungary became a member of the IMF in 1982. The country agreed on a stand-by program in 1988; Czechoslovakia did not become a member of the organization during the communist period at all. Hungary passed a bankruptcy law in 1986, even if it was not used. A two-tier banking system was introduced in 1987—the previous monobank split into the central bank and three commercial banks. The economy started to open that year too—in 1990 70 percent of the country's production was already under pressure from foreign competition (Stojanov 2004). Hungarian companies were allowed to trade internationally on their own accounts.

A new commercial code was approved in 1988. The main legal forms were the same as in the market economy, and all of the legal forms were equal. The government started to transform state companies into joint-stock companies in 1989.

In 1988 Hungary was the first Central European country to incorporate value-added and personal income taxes into the tax system. Furthermore 63 percent of all prices were liberalized in 1989.² There were continuous devaluations of the forint—from 45.8 to USD in 1986 to 63.2 in 1990 (Vintrová 1992). Ownership structure changed as well. Some private companies, especially in services and trade, were allowed to exist and their numbers increased steadily (see Table 11.1). There was even support for new private entrepreneurs. According to a 1988 act, newly created businesses got discount on tax on profit of 55 percent in the first year, 35 percent the second year, and 25 percent the third year (Earle et al. 1994).

Table 11.1: Number of private shops and restaurants in Hungary

Year	Shops	Restaurants
1970	9,043	682
1980	9,946	1,457
1985	19,968	5,487

Source: Bethkenhagen (1989).

The private sector created 3 percent of national product in 1970 (Bethkenhagen 1989). By 1989 it created already more than one-quarter (Holman 2000) and two-thirds of Hungarians had income from private activity in addition to their main jobs in a state company or a cooperative. These numbers are several times higher compared to Czechoslovakia's numbers but are of course far from any market economy.

The Hungarian economy was ahead of the others and to certain degree prepared for the shift to the market economy. But at the same time, there were significant problems on the macroeconomic level. The country had massive deficits of the public finance and trade. Both of them can be connected to the "goulash communism" because government had to "bribe" its citizens. The deficits were together responsible for a large foreign debt—70 percent of GDP (Markiewicz 2003). This size of the deficit was crucial for the transformation steps. But this number was still lower than in Poland. Another way of measuring external debt can be seen in Table 11.2.

Table 11.2: External debt/exports of goods and services

	1985	1986	1987	1988	1989	1990
Czechoslovakia	32.4	33.8	36.2	40.2	45.1	56.3
Hungary	148.5	166	174.9	173.8	169.7	171.7
Poland	252.1	259.5	294.8	254	261.7	251.5

Source: Jonáš (1997).

The government role in the form of redistribution used to be rather high in Hungary during the communist period, in fact one of the highest even among the centrally planned economies (see Table 11.3).

The structure of the economy was troublesome too. We can see a relatively high percentage of people still working in agriculture in Table 11.4. Conversely, Hungary had relatively low share of industry, which was assumed to be the most problematic part of the economy in the transformation process. And it meant relatively lower ecological burden too. At the same time, Hungary had the highest proportion of people working in services in Central Europe.

How the reforms and changes during the communist reign turned out in the economy? The overall trend in Hungary was similar to the other countries of the Eastern Bloc after World War II (see Figure 11.1). But the growth was affected by more significant fluctuations than in Czechoslovakia. The economy was able to achieve strong growth during the 1950s but in the following decades

Table 11.3: Government incomes and expenditures, 1989 (% of GDP)

Country	Incomes	Expenditure
Czechoslovakia	62.1	64.5
Hungary	61.3	63.7
Poland	46.8	48.7
Romania	45.7	40.7
Bulgaria	57.7	60.1
Soviet Union	43.8	50.7
USA	34.3	36.5
Germany	45.7	45.9
Canada	40.3	43.9
France	46.2	47.8

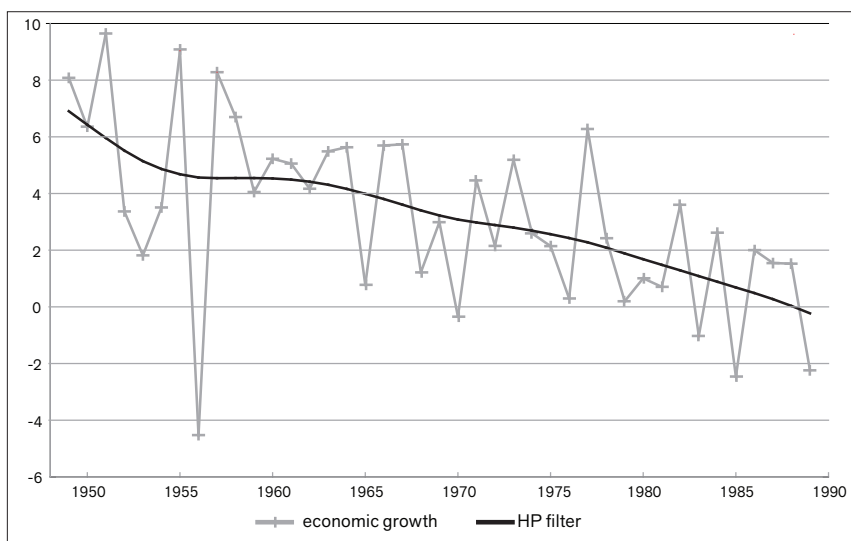
Source: Jonáš (1997).

Table 11.4: Structure of employment in 1990 (shares in %)

	ČSSR	Hungary	Poland (1989)
Agriculture	11.8	17.5	26.7
Industry	45.4	36.1	36.6
Services	42.8	46.4	36.7

Source: Berend (2009).

Figure 11.1: Economic growth during the communist regime and its trend estimated with HP filter, 1948–1989



Source: Maddison (2010).

this ability declined to a very low growth during the 1980s (the average was only 0.7 percent per year; Maddison 2010). The general trend is clearly visible in Figure 11.1. Economic reforms generally did not lead to improvement in the trend of economic growth. On the contrary, economic results were worsening.

In the 1980s inflation was relatively high as well (see Figure 11.8)—on average it reached 9 percent (IMF 2010) which was much higher in comparison to Czechoslovakia but a good result compared to Poland. Hungary had a high level of debts and deficit of trade balance. Surprisingly, for a planned economy, there was even a small number of unemployed people in 1989—12,000 or 0.5 of labor force (EBRD 2007).

To sum up, Hungary was relatively prepared for the transformation at the level of formal institutions and at the microeconomic level. By contrast, there were problems at the macroeconomic level. Relative openness of the society resulted in a relatively higher proportion of people/economists with knowledge about the functioning of the market economy. Some Hungarians even suffered a kind of “hubris” at the end of the 1980s that was caused by the progress of the reforms. They thought that the transformation process will be smooth because of the steps that had been already taken in the decade. This attitude led to a belief that radical steps were not necessary and it lasted until the mid-1990s when people realized that unpopular steps were necessary (Srholec 2001). General comparison of the situation at the beginning of the 1990s is presented in Table 11.5.

Table 11.5: Basic economic indicators at the beginning of the 1990s

	CR	HUN	POL	SLV	SLOVE	BUL	RUM	CROA	RUS	UKR
Inhabitants in millions	10.36	10.36	38.11	5.3	1.99	8.72	23.21	4.78	148.29	54.87
Economic activity in %	51.6	52	42.7	37.9	46.2	47	46.9	32.8	50.8	48.7
Employment in industry % of total	37.9	29.7	28.4	33.9	43.5	36.6	37.6	35.7	30.3	31
Investment in %	37.9	29.7	28.4	33.9	43.5	36.6	37.6	35.7	30.3	31
GDP in billions of USD PPP	98.97	59.6	160.86	38.68	18.36	39.13	92.75	23.26	889	215.64
GDP/person USD PPP	9,550	5,750	4,221	7,301	9,225	4,487	3,996	4,866	5,995	4,163
EX per person in USD	873	922	376	545	20,70	1,541	249	841	480	218
IM per person in USD	945	832	250	606	2,377	1,506	396	1086	551	230
Gross external debt per person	686	2,077	1,270	561	977	1,154	10	607	378	67
in % of GDP	21.9	65.1	82.2	19.3	11.2	17.3	0.6	10.9	5.1	1.2

*1990 or the closest year.

Source: Chvojka and Zeman (2000).

11.3 Political development in transition

The first free elections took place in March/April 1990. The first postcommunist government was created by József Antall (1932–93). The government was central-right and consisted of Christian and National parties. It had a strong majority of 60 percent in the parliament, giving the government a stable position. But its position was weakened by taxi and lorry drivers revolt in September 1990, which had a devastating effect on further reforms. One of the government's achievements was that Soviet troops left Hungary in mid-1991. In the same year, the association agreement with the European Community was signed.

There was an extensive discussion about the role of the previous communist elites after the political changes in all the postcommunist countries. In Hungary, the Communist Party transformed itself into the Hungarian Socialist Party (MSZP), a standard left-wing social democratic party, after 1989. But there is an interesting question of the specific role of the nomenclature after the political change. A survey was conducted among these previous elites in 1993 and its result can be seen in Table 11.6, which shows that only a fraction of the previous nomenclature occupied high political positions. At the same time, only a small percentage of them became entrepreneurs, in all of the Central European countries.

Table 11.6: Occupational destinations in 1993 of people who were in nomenclature positions in 1988 (by country)

Occupation in 1993	Czech Republic	Hungary	Poland
All in position of authority	51.7	43.1	51.2
High political office	3.0	6.4	9.0
High manager—public	16.2	11.2	13.4
High manager—private	12.8	2.4	9.1
High cultural office	1.1	4.4	7.1
Low-level managers	12.6	13.0	8.6
Entrepreneurs	6.0	5.7	4.0
Professionals	12.2	19.9	13.9
Workers	12.6	5.5	9.5
Retired early (younger than 65)	15.4	19.1	17.2
Other retired and unemployed	8.1	12.6	8.2
All respondents	100%	100%	100%
(number)	(468)	(803)	(849)

Source: Eyal, Széleányi, and Townsley (1998).

The MSZP won the next elections in 1994 by a landslide. Due to the economic situation it was forced to introduce tough economic measures. A right-wing coalition government, with Fidesz as the main party, was created after the elections in 1998. Hungary joined NATO during its regime. Fidesz won the next elections in 2002 as well but was not able to assemble a government that was formed by left-wing parties instead.

The country adhered to democratic principles for the whole period and became a member of the European Union in 2004. But there is a lasting dissatisfaction with the transformation process and life in general in Hungary. The results of a 2009 survey are depicted in Table 11.7.³ I do not have any reasonable explanation for this attitude. We can consider high expectations of the Hungarians at the end of the 1980s and a possibility that they were overall content with the semicapitalist system of the goulash communism.

Table 11.7: Results of a survey comparing the economic situation in 1991 and 2009
(Answers to the question: "Thinking back to 1989–91, do you strongly approve, approve, disapprove, or strongly disapprove that your country moved from having a state controlled economy to having a market economy?")

			Strongly approve	Approve	Disapprove	Strongly disapprove	DK/Refused	Total
Poland	Fall	2009	26	45	11	4	13	100
	Spring	1991	25	55	7	4	9	100
Czech Republic	Fall	2009	28	51	12	3	5	100
	Spring	1991	42	45	4	3	6	100
Hungary	Fall	2009	9	37	27	15	13	100
	Spring	1991	22	58	9	1	10	100

Source: Pew Research Center (2009, 2013).

11.4 Basis of economic transformation

The sequence of the reforms in Hungary was under similar discussion as in other countries at the beginning of the transformation period. The Hungarian specific was that its Communist Party had started reforms already before the fall of the regime. Hungarians then naturally believed that it was not necessary (or it was *de facto* impossible) to follow radical reforms. There was a general belief that slower reforms can achieve the same results with lower costs. By contrast, proponents of the shock therapy approach did not trust the government's ability to establish a market economy. Consequently, the first period of Hungarian transformation is often described as gradualist but the definition of gradualism carries with it inherent problems. Some of the Hungarian measures—especially bankruptcy law—can be seen as extremely radical.

11.4.1 Gradualist period

Most authors (for example, Holman 2000; Lavigne, 1999) regard the development in the first half of the 1990s in Hungary as gradualism. There is a good basis for this view as many important and necessary steps in the direction toward the market had been already taken or at minimum prepared. I have already mentioned the liberalization of prices—in 1991, 90 percent of all prices were liberalized (Vintrová 1992). The economy was partly deregulated as well; Hungary did not have a huge surplus of money in circulation and their exchange rate was relatively sound (Vintrová 1992). The progress in institutional development was also under way.⁴ Under these circumstances it is hardly imaginable to carry out a real radical economic transformation not to mention the shock therapy. At the same time, I should mention that there was no demand for a quick or radical change.⁵

The Antall government had three main tasks—to keep creditworthiness of the country, reduce inflation, and reduce the growing public deficit (Laki 1993). The last of these tasks was the most demanding one because after the collapse of the communist regime problems with public finance deepened. With the fall of the regime the state income declined but the cabinet was not able to simultaneously decrease its expenditures. On the contrary, the government quite often took on responsibilities for former state companies

that had provided social services to the public and it led to another increase in spending (Allen and Hass 2001).

State-owned companies were losing money and their gross loss reached 2.6 percent of GDP in 1990, 8.4 percent in 1991, 14.2 percent in 1993, 10.1 percent in 1993, and 7.5 percent in 1994 (Borish and Noël 1996). The IMF recommended that the Hungarian government decrease deficits but the cabinet was not able to fulfill these expectations. A part of this deficit was even monetized as we can see in Table 11.8.

Table 11.8: Overall government balances and central-bank financing of governments, 1992–1997
(as % of GDP)

Country	Overall government balances						Central bank financing					
	1992	1993	1994	1995	1996	1997	1992	1993	1994	1995	1996	1997
Czech Republic	...	...	-1.2	-1.8	-1.2	-2.1	...	-2.1	-2.4	-1.0	-0.8	0.7
Hungary	-6.9	-8.5	-8.3	-7.1	-3.1	-4.6	16.5	13.2	11.2	7.5	7.3	1.7
Poland	-7.5	-4.0	-2.0	-2.7	-2.5	-2.3	5.2	1.5	1.5	0.1	0.1	0.5

Source: Dabrowski (2003).

The government was unwilling to execute unpopular steps—like decline in real wages or devaluation (as opposed to Czechoslovakia and Poland).⁶ Holman writes that in all countries real wages declined at minimum by 20 percent and for example in Bulgaria by 50 percent but Hungary was an exception (Holman 2000; see also Table 11.9). Thus the wage costs remained relatively high in comparison to other Central European countries. There were growing imbalances as a consequence. The IMF criticized the government for not keeping fiscal promises in 1992 when the country significantly exceeded the agreed ceiling, mainly due to social requirements.

Table 11.9: Real wages (annually, in percentage change)

	1988	1989	1990	1991
Czechoslovakia	2.1	0.8	-5.8	-23.5*
Hungary		-4.3	-3.8	-7.5**
Poland	15.9	-4.4	-29.7	2.0**
Yugoslavia		14.0	-22.0	X

* January–September 1991; ** - preliminary

Source: Winiecki (1993).

However, Hungarian government proceeded with reforms of the business and the financial sectors. Steps were taken to improve the legal system, to privatize, to improve the antitrust policy, and to make amendments in the bankruptcy law. Hungarian gradualism is highly questionable if I take into account the bankruptcy legislation. A tough new code was in effect since the beginning of 1992. If a company was not able to pay its debts within ninety days it had to start bankruptcy proceedings itself. The law was in effect for eighteen months and 5,000 companies went bankrupt (Holman 2000). These companies together had created 10 percent of the Hungarian GDP (Nestor and Thomas 1995). This bankruptcy proceeding was in fact a privatization method because around 500 large companies that went bankrupt were transferred into private ownership (Nestor and Thomas 1995). The process had negative impact on the banks that were affected by the growing number of classified credits. I should recall that bankruptcy legislation, on the contrary, was very weak in the Czech Republic—in the same period, the first law was approved only in 1993 and it could not be applied against companies waiting for privatization. Politicians in Hungary realized that their code was too tough and amended it in 1993. With the relaxed rules provided by the amendment, fewer than 100 companies went bankrupt in 1995 (Srholec 2001). Srholec also thinks that the process cleaned the economic environment and improved the position of the Hungarian banks in the long run.

Over time, we can see progress on the microeconomic level and unsolved problems on the macroeconomic level. Conversely, Czechoslovak reformers kept the macroeconomic values relatively stable in the first years of transformation but achievements on the microeconomic level were limited.

The economic results in Hungary in this period were not positive. If the country represents the case of a gradual reform then gradualism was not able to avoid transformation recession. Hungary suffered similar or deeper decline as other countries in Central Europe. Unemployment rate was relatively high. Inflation development did not embrace the typical jump after the price liberalization that took place in other countries but there was a continuously higher inflation rate. On the positive side, there was a relatively high level of foreign capital incoming into the country. It had its roots in the previous liberalization because foreign investors were familiar with situation in Hungary. At the same time, deficit of the current account appeared.

11.4.2 The Bokros package

In 1994, Hungarian economy faced a difficult situation with many imbalances (see Table 11.10). Government deficit reached 8.4 percent of GDP, public debt was 88 percent of GDP, the deficit of the current account stood at 9.5 percent of GDP, inflation was 18.8 percent, and the unemployment rate nearly 11 percent. The level of imbalances was critical; the IMF placed Hungary among the three most vulnerable economies in the world after the Mexico currency crisis (Holman 2000). As a consequence, the spread on external debt to Libor rate reached 500 basilar points (Stojanov 2004).

The elections took place in 1994. The winners—the Social Democrats agreed to apply a program that is often called the Bokros package, named after the Minister of Finance Lajos Bokros (1954–). The set of reforms was developed in cooperation with the IMF. The government promised to follow steps in the direction toward austerity and the IMF in exchange provided the country with a loan of USD 300 million and the EBRD released its funds as well (Hanley, King, and János 2002).

Table 11.10: Selected economic indicators for Hungary, 1993–1998

	1993	1994	1995	1996	1997	1998
Real sector: % change						
Real GDP	-0.6	2.9	1.5	1.3	4.6	5.1
Exports of goods/services (real)	-10.1	13.7	13.4	7.4	26.4	16.3
Imports of goods/services (real)	20.2	8.8	-0.7	5.7	25.5	22.5
Fixed investment (real)	2	12.5	-4.3	6.7	9.2	11.4
Private consumption (real)	1.9	-0.2	-7.1	-2.7	1.7	3.8
Average CPI	22.5	18.8	28.2	23.6	18.3	14.3
Gross wage growth (real)	-0.5	5.1	-8.9	-2.6	3.4	4.4
Real effective exchange rate (unit labor cost)	4.3	7.3	19.4	8.6	2.7	8.5
Unemployment rate (end period)	12.6	10.9	10.9	10.7	10.4	9.1
Real sector: % of GDP						
Exports of goods and services	26.4	28.9	37.3	38.9	45.5	49.8
Imports of goods and services	34.6	35.4	38.5	39.9	46	52.3
Fixed investment	18.9	20.1	20	21.4	22.1	23.2

General government						
Overall balance (excl. privatization)	-6.6	-8.4	-6.4	-3	-4.8	-4.7
Overall balance (including privatization)	-6	-7.5	-3.2	0.8	-1.8	-4.4
Primary balance (excl. privatization)	-2.7	-2.2	2.2	3.7	2.7	1.6
Expenditures	60.8	60.4	54.3	49	49.2	47.1
Public debt	90.4	88.2	86.4	72.8	63.9	60.2
External accounts						
Trade balance	-8.4	-8.8	-5.5	-5.9	-3.8	-4.4
Current account balance	-9	-9.5	-5.3	-3.7	-2.1	-4.8
Foreign direct investment	6	2.8	10	4.4	3.6	3
Gross external debt	63.7	68.4	70.9	61	51.9	56.3
Net external debt	38.7	45.4	36.6	31.4	24.4	26

Source: Stojanov (2004).

The reform package offered other remedies. The exchange rate was devaluated by 9 percent and the regime changed to a crawling peg.⁷ At the same time, the government introduced a temporary import surcharge—8 percent on all noninvestment goods. The government applied many restrictive measures as well—it decreased the number of jobs in state companies; university tuitions were introduced; rules for sick benefits were tightened; and child benefits were not blanket any more. Agreements with most of the trade unions on real wages reduction were reached. At the same time, the government decided to quickly privatize nearly all state companies, bar railways, and the post office—mostly in the form of foreign direct investment (see Table 11.11).

Holman adds that these general restrictive measures were similar to Czechoslovak steps at the beginning of the transformation process and it seems that they are unavoidable in the transformation process (Holman 2000). I should remark that some of the measures were revoked or weakened by the parliament or the constitutional court in the following years.

The goal of these steps was obvious. The government wanted to reduce deficits of the public finance and the trade balance and increase competition in the economy. The consequences of the measures were harsh—government expenditure declined by 10 percent of GDP; real wages decreased by 12 percent in 1995 and 4 percent in 1996, and economic growth slowed down to just 1 percent in both 1995 and 1996 (Holman 2000; Stojanov 2004). At the same time the main imbalances in the economy narrowed—the trade defi-

cit declined between 1994 and 1996. The government deficit, without incomes from privatization, diminished from 8.4 percent to 3 percent in the same period as well (see Table 11.12). Overall, the development of public finance during the first decade can be seen in Figure 11.2. We can see that average deficit was relatively high—between 1990 and 2004 5.5 percent of GDP (EBRD 2007). These results were generally the worst among the Central European countries.

Table 11.11: FDI inflows into Hungary, 1972–2001 (in millions of USD)

	In cash	Of which privatization income	as %	Investment in kind	Total
1972–1989	387	-		783	1,170
1990	311	20	6.4	589	900
1991	1,459	435	29.8	155	1,614
1992	1,471	492	33.4	170	1,641
1993	2,339	1,163	49.7	142	2,481
1994	1,147	103	9.0	173	1,320
1995	4,453	3,370	75.7	185	4,638
1996	1,983	618	31.2	57	2,040
1997	2,085	1,827	87.6	22	2,107
1998	1,935	485	25.1	11	1,946
1999	1,651	295	17.9	6	1,657
2000	1,600	0	0.0	0*	1,600
1990–2000	20,434	8,808	43.1	1,510	21,876

*in fiscal year 2000 this figure was equal to USD 280, which is 0 when rounded to millions.

Sources: Csáki (2002) and author's own calculations.

I can offer another conclusion that resulted from the crisis. We should notice that Hungary solved the problems with outer balance by admitting devaluation and inflation. On the contrary, after the Czech currency crisis the Czech exchange rate soon returned to the nearly precrisis level and inflation declined. Foreign investors did not evaluate the development in Hungary as negative and were willing to invest capital in the country.

I should mention that changes in the banking sector were connected with the Bokros package too. Until the mid-1990s, foreign institutions were banned from keeping more than 25 percent in a Hungarian bank without a special permission. This rule was abandoned after 1995 and all large Hungarian banks were privatized into the hands of European financial institutions until 1997 (Hanley et al. 2002). Holman (2000) comments that it was necessary to

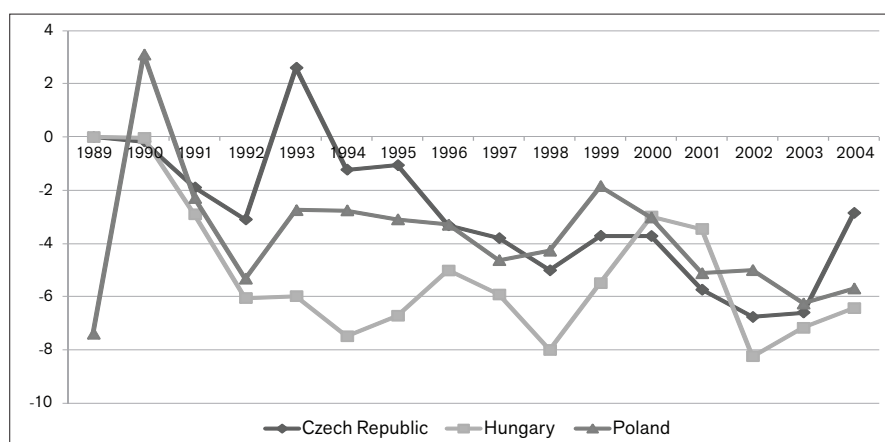
clean the banking sector before privatization and that it cost around USD 4 billion.

There were changes in the exchange rate policy as well. The overall positive development of the economy and drift toward the market economy was appreciated by a membership in the OECD in May of 1996. Some see the period after 1997 as the best of the whole transformation (e.g., Gabrisch and Hölscher 2006).

11.4.3 Currency problems at the beginning of the twenty-first century

The economic development after applying of the Bokros package is generally deemed to be positive. Unfortunately, this prosperous period lasted only for a few years, when Hungary had to face growing problems at the beginning of the twenty-first century. Foremost, Hungarian government created notorious problems in the fiscal field. The main culprits were government expenditures. Gabrisch and Hölscher state that wages in the public sector increased by 12–13 percent in 2002 alone (Gabrisch and Hölscher 2006; see also Figure 11.2). Growing deficit of the public finance can be seen in the previous chart. Trade was another source of instability because its deficit was getting larger. The trade deficit reached between 6 percent and 8 percent of GDP at the beginning of the twenty-first century. It was partly caused by slowing down of European

Figure 11.2: Deficit in public finance (% of GDP)



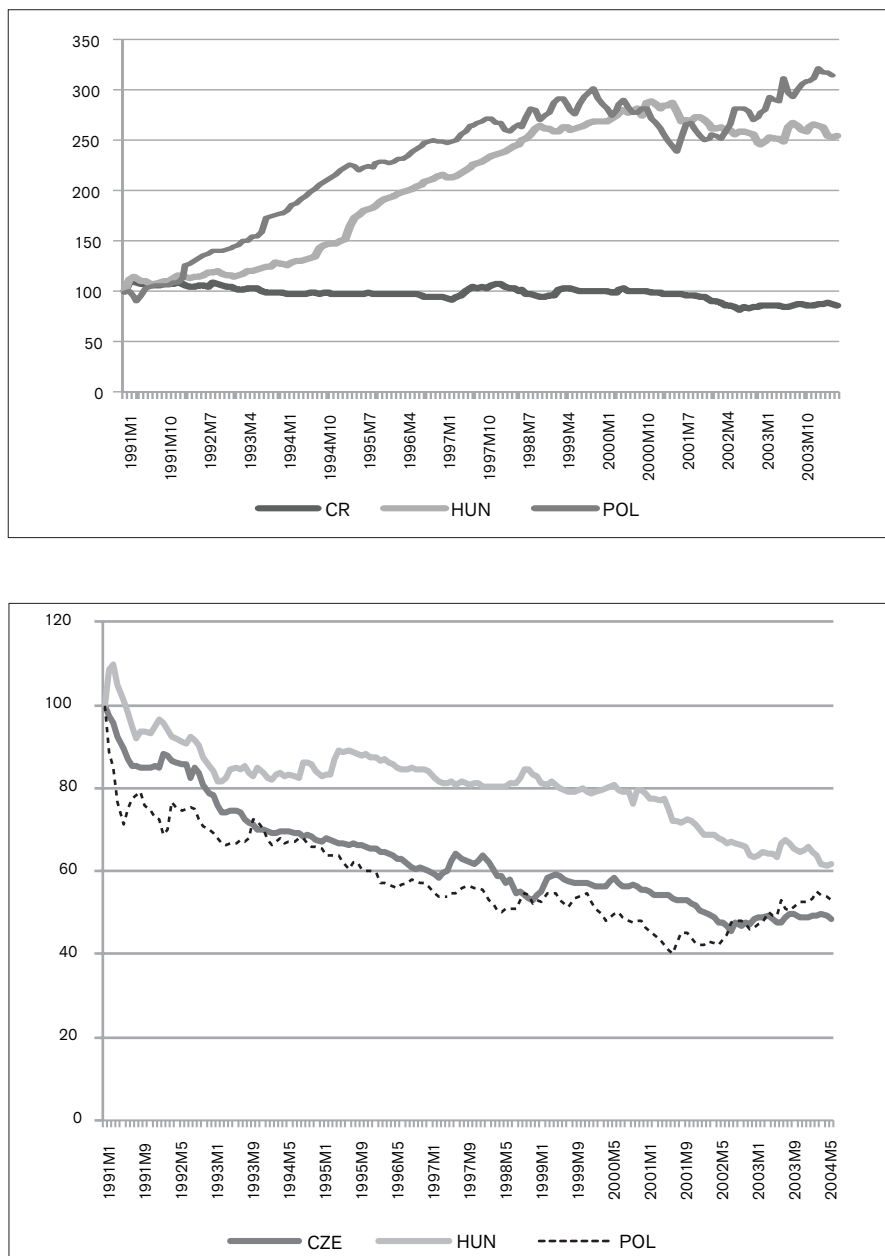
Source: EBRD (2007).

economies but mostly due to the decline of competitiveness that was caused by wage growth. The central bank was worried about lasting inflation pressures and responded with monetary restriction. It widened the fluctuation band from ± 2.25 to ± 15 in May 2001. In the summer of 2001, the system of inflation targeting was introduced and the currency became fully convertible. In October of the same year, the crawling peg was abandoned and central parity of the forint was fixed. Generally, the central bank shifted its emphasis from control of exchange rate to inflation targeting but the central parity and the fluctuation zone were still valid. It means that the central bank tried to hit two targets, inflation and exchange rate, by one tool—interest rates. This task was made even more complicated by free movement of capital. Yet Hungarian authorities decided to fix the currency when inflation was declining and pressures on the nominal exchange rate were expected to be lower.

Shift to the fixed central parity meant a significant change in Hungarian economic policy because the country had followed strategy of stabilising the real exchange rate, on the contrary to the Czech case, during the first decade of the transformation as we can see in Figure 11.3. The Czech currency meanwhile strongly appreciated in real terms.

After these changes, fiscal policy remained loose and the central bank kept interest rates high. There was appreciation pressure and the exchange rate was above the parity and close to the appreciation bend in the following months. Jonáš wrote that there were high expectations on appreciation of the currency that fully appeared in speculative pressures in January 2003 (Jonáš 2003). A potential change of the central parity would have meant possibility to earn money easily. The central bank was in conflict with the government that did not accept the idea of revaluation. In the end the bank decided to keep the exchange rate in the zone and carried out massive intervention on the foreign exchange market—the estimation is that the central bank spent 5 billion euros (8 percent of Hungarian GDP; Jonáš 2003). These interventions led to increase in money in circulation and monetary policy was even more relaxed by declining of the interest rates by 2 percent. These steps resulted in the loss of credibility of the central bank. The government initiated a slight devaluation of the central parity of the forint to euro in June 2003 by 2.26 percent to please exporters, but the currency's ± 15 percent intervention band remained unchanged. This unexpected shift in the exchange rate band caused considerable confusion in investors and declining confidence in the currency. The forint took a sharp downward turn (Magyar Nemzeti Bank 2004). The

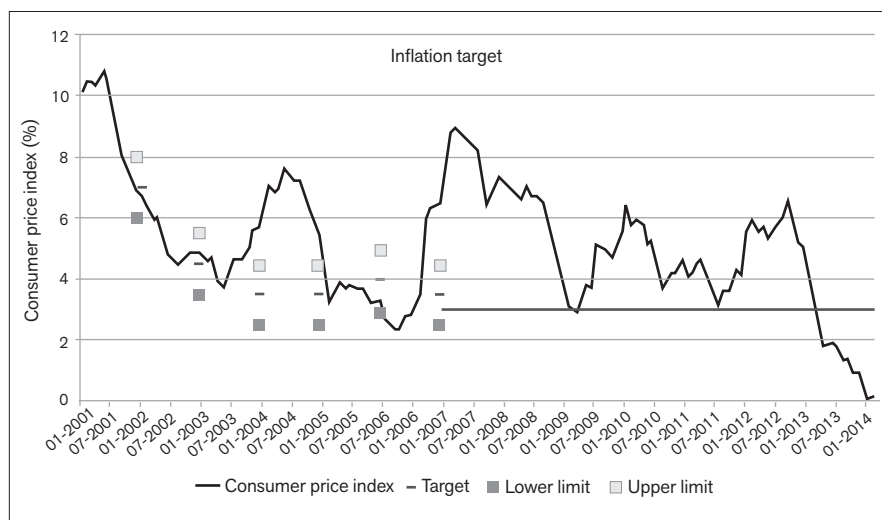
Figure 11.3: Nominal and real exchange rate in Hungary, Poland, and the Czech Republic, 1991–2004 (1991 = 100)



Source: IMF, <http://elibrary-data.imf.org/>.

exchange rate weakened from 245 HUF/EUR in April to 266 HUF/EUR in June. But the currency remained within the stronger half of the fluctuation band and it returned to its previous values in 2004. However, there was another consequence of the situation—inflation increased and overcame the inflation target (see Figure 11.4). The whole case seems to be a proof that it is highly difficult to keep inflation and exchange rate targets at the same time.

Figure 11.4: Inflation, its projection and inflation target at the end of 2004



Source: Magyar Nemzeti Bank (2015)

These troubles were only minor obstacles on Hungary's way into the EU. The EU year to year analysis concluded in 2002 that Hungary passed the Copenhagen criteria—it meant among others that the economy was considered a well functioning market economy. The country entered the EU in 2004.

11.5 Privatization

In the field of ownership, the biggest difference among the Central European countries at the beginning of the transformation process was in the role of managers of state companies. In Hungary their role was much more accepted than in Czechoslovakia, where they were deemed as foremost high-ranking

communists. As a consequence, the managers were allowed to gain control over thousands of companies in Hungary as early as at the end of the 1980s. This process is sometimes called a spontaneous privatization.

The attitude of the public toward privatization was definitely not unambiguous as we can see in the following survey. The numbers say that restitutions (reprivatization) had low support in Hungary and there was a relatively high resistance to privatization as such—one of the highest numbers in all of Eastern Europe. But at the same time, we can see the strongest support for selling companies at the highest price. In a survey from mid-1991, 34 percent of the respondents were against privatization as such but as many as 55–60 percent were against privatization of their own company (Laki 1993). At the same time, there was strong sentiment against foreign investment and return of the previous landowners.

Table 11.12: Public survey answers to the question:
"How would you solve the problem of ownership, November 1990–August 1991?"

	Bulgaria	Czechoslovakia	Estonia	Hungary	Lithuania	Poland	Romania	Slovenia	Ukraine
Return to previous owner	21	34	34	12	14	17	7	20	5
Sell to the highest price	15	17	10	29	10	12	19	22	12
Self-management	35	27	39	28	57	47	31	40	53
Keep in state possession	30	22	18	31	19	24	44	18	31

Source: Kende (1993).

Some of the authors consider Hungarian and Polish, privatizations to be decentralized when compared to the Czechoslovak one. At the same time, Hungarian and Polish privatization around the turn of the 1990s is often described as "spontaneous" or "wild." The label means that companies were privatized into the hands of the management in the first years of the transformation. Or, seen from a different angle—the respective managers were able to gain control over their companies. This development was the result of an important role that management of the companies played at the end of the communist era. Managements were gaining independence and autonomy since the 1960s. It was in direct contrast to Czechoslovakia where the power was fully in the hands of the center until the fall of the regime.

In addition, managements had to compete with other potential buyers in the Czechoslovak case later on. But I must say that there are probably no estimates of the size of the spontaneous privatization and for example Soós considers it as relatively small (Soós 2011).

The 1988 act that allowed transformation of the state-owned firms into joint-stock companies in Hungary was a turning point that enabled managements to take control over the enterprises. Insiders kept playing a dominant role in Hungarian privatization at the beginning of the 1990s, when the government was not able to keep full ownership or sell a company to outsiders without consent with the insiders (Earle and Estrin 1996). Important role of management and its abuses of power was linked with scandals and embezzlement. The public turned against this form of privatization, which resulted in slowing down of the whole privatization process (Srholec 2001).

Legal environment was developed and the State Property Fund (SPA) was founded in 1990. This organization became a central agency responsible for privatization. In 1990, the SPA controlled 1,975 state companies (1,700 in industry and the rest in agriculture). The creation of SPA probably prevented even worse abuse of the situation because it had the right to approve all sales (Earle and Estrin 1996).

Meanwhile the government started the process of small privatization. The first program was called preprivatization and it started in May 1990. It was targeted at retail and the goal was among others to stop spontaneous privatization. Roughly 10,000 units were sold or leased between 1991 and 1993. This way of privatization concerned mostly small shops and restaurants. The main privatization method was auction. An important factor was that employees of the respective shops gained majority of the property. Changes in property ownership can be seen in Table 11.13.

Meanwhile, the large privatization proceeded as well. The main methods were auctions and tenders; an important role was played by foreign capital (see Table 11.14). Seven percent of state assets were sold for compensation certificates distributed to the victims of the fascist and communist regimes.

Hungarian privatization did not avoid scandals. For example, eight out of ten members of the privatization agency were forced to resign in 1994 due to accusations of corruption.

Table 11.13: Change in the affiliation of units in the retail and catering sector, 1988–1992

Year	1988	1990	1992
State enterprises	26,366	17,410	14,000
Incorporated companies*	671	6,240	30,000
Cooperatives	27,349	22,323	18,000
Private entrepreneurs	34,541	60,141	102,755
Total	88,927	106,114	164,755

*includes limited partnership, limited liability companies, and joint stock companies; privately or state-owned.

Source: Earle et al. (1994).

Table 11.14: Privatization revenues of the state privatization companies, 1990–2000 (in billions of HUF)

	Sales and asset management	Cash revenues	Of which, hard currency	Hard currency/ Cash (%)
1990	0.67	0.67	0.53	79
1991	30.43	30.35	24.61	81
1992	66.91	65.90	40.98	62
1993	164.50	133.63	110.67	83
1994	148.87	46.36	10.95	25
1995	471.93	437.80	411.48	94
1996	162.63	119.46	92.73	77
1997	340.61	317.70	208.60	66
1998	104.80	98.70	38.62	39
1999	114.95	99.23	70.00	71
2000	21.13	19.83	0.00	0
Total:	1628.2	1369.6	970.6	71

Source: Csáki (2002).

Until the mid-1995, the SPA divested itself of 75 percent of the previous ownership, which nevertheless represented only 35 percent of state property (Stojanov 2004). The government still kept possession of gas distribution, railways, airlines, telecommunication, banks, and chemical companies. This changed with the Bokros package. The government urgently needed to decrease fiscal deficits and one way was to intensify the privatization process. It was decided that all the state property with the exception of railways, post offices, and national parks would be sold. The rest to be sold included The Saving bank (OTP) and the main telecommunication company among others. The amount of property for privatization reached HUF 1.3 trillion out of 1.6 trillion of the overall state ownership (Stojanov 2004). A typical method was

a direct sell to a foreign investor, which resulted in a huge inflow of foreign direct investment in this period. A growing role of foreign ownership can be seen in Table 11.15. Until the end of 1997, the government sold property worth HUF 790 billion and its debt decreased from 86 percent of GDP in 1995 to 60 percent in 1998 (Stojanov 2004).

Table 11.15: Ownership of manufacturing firms (% of registered capital)

Types of ownership	1992	1993	1994	1995	1996
State	55.2	39.2	29.3	19.9	14.4
Municipal	8.8	1.6	1.6	1.0	0.9
Individual private		8.8	9.4	10.1	9.5
Domestic corporate	0.1	15.0	17.9	18.2	19.4
Employee	20.5	1.0	1.5	1.4	1.2
Foreign	3.6	30.9	37.1	46.7	51.1
Cooperative		2.6	1.9	1.4	1.2
Other		0.9	1.3	1.3	2.3

Source: Stojanov (2004).

Private sector quickly advanced at the beginning of the transformation process in Central Europe as can be seen in Table 11.16. We can see from the table that Hungary achieved a 50 percent share of the private sector in GDP already in 1993.

Table 11.16: Private sector share in GDP (in %)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001–2004
Czech Republic	10	15	30	45	65	70	75	75	75	80	80	80
Hungary	25	30	40	50	55	60	70	75	80	80	80	80
Poland	30	40	45	50	55	60	60	65	65	65	70	75

Source: EBRD (2007).

11.6 Economic results

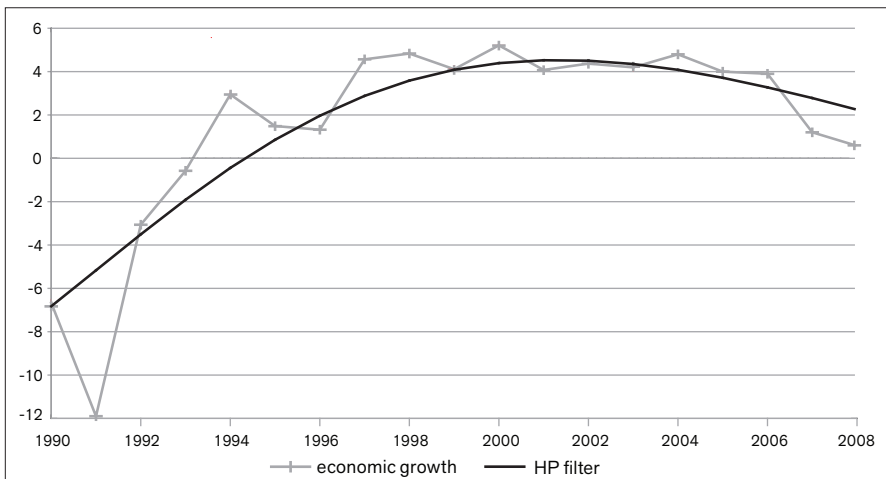
I now turn to the analysis of main economic indicators—development of GDP, inflation, unemployment, and indicators of foreign relationships.

11.6.1 Economic growth

Figure 11.5 depicts Hungary's economic growth. We can see from the figure that the country suffered from transformation recession similarly to other countries in Central Europe. A slower pace of the reforms (gradualism) did not help to avoid the recession. There was visible slowing down after 1995 as well. But the general trend is positive. We should compare the results of HP filter during the communist regime with results after 1990. Hungarian economy was able to achieve growth around 3 or 4 percent after overcoming the transformation recession.

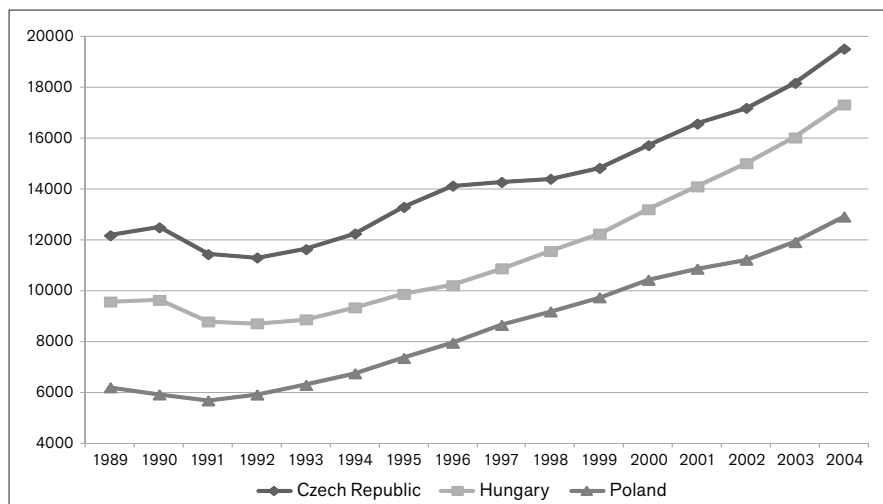
Meanwhile, GDP per person followed a similar trajectory. The indicator declined at the beginning of the transformation process regardless of the pace of the reforms. In 1995, it reached the prerecession level and steadily grew in the next years. It nearly doubled in comparison to 1989 by the end of 2004 (see Figure 11.6).

Figure 11.5: Economic growth after 1990 and its trend estimated by HP filter (in %)



Source: Maddison (2010).

Figure 11.6: GDP per person in USD based on PPP, 1989–2004



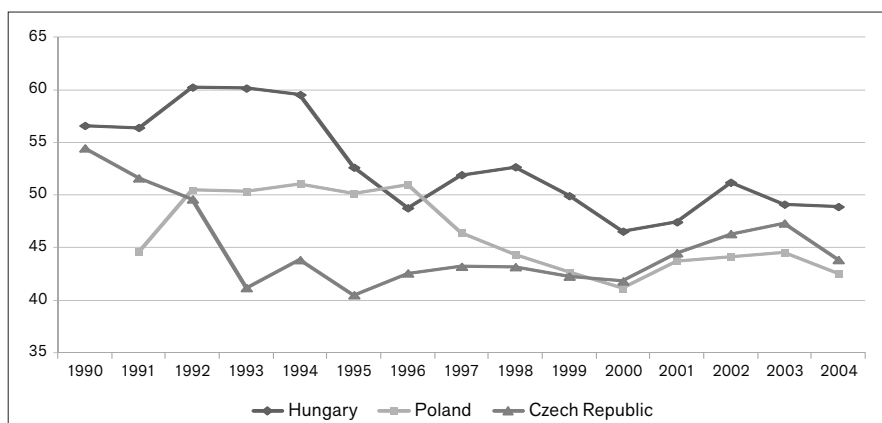
Source: IMF (2010).

11.6.2 Structure of the economy

Important changes took place in the role of the government in the economy. We can see a surprising development in Hungary, where the role of the government (expenditure to GDP) in fact increased from an already high level at the beginning of the 1990s. And it declined only with the Bokros package. During the 1990s, the trend was generally declining among Central European countries. This changed in the new millennium when the share of the government increased in all countries—see Figure 11.7.

Simultaneously, changes in the structure of the economy took place, as we can see in Table 11.17. We should notice that the share of industry was very low in Hungary at the beginning of the transformation and even slightly increased during the period. The share of agriculture declined in this country as in the other countries of the region. And the share of the service sector was consistently high during the whole transformation period.

Figure 11.7: Government expenditure, 1990–2004 (% of GDP)



Source: EBRD (2007).

Table 11.17: Structure of the economy:
Share of industry (I), agriculture (A), and services (S) (% of GDP)

		1989	1990	1991	1992	1995	1997	1999	2001	2003	2004
Czech Republic	I		36.7	37.9	39.4	33.3	35.9	35.5	37.5	38.2	40.0
	A	6.3	8.2	5.6	4.6	4.7	5.0	3.9	3.7	3.4	3.3
	S		55.1	56.5	56.0	62.0	59.1	60.6	58.7	58.3	56.7
Hungary	I			21.0	20.4	23.1	25.0	26.7	26.6	26.7	26.5
	A			7.8	6.5	5.9	5.8	5.3	5.0	4.2	6.1
	S			71.2	73.1	71.0	69.2	68.0	68.4	69.1	67.4
Poland	I	44.1	44.9	40.2	34.0	32.1	30.7	29.7	29.5	29.6	30.8
	A	11.8	7.4	6.8	6.7	5.6	4.5	3.2	3.2	2.6	2.5
	S	44.1	47.7	53.0	59.3	62.3	64.8	67.1	67.3	67.8	66.7

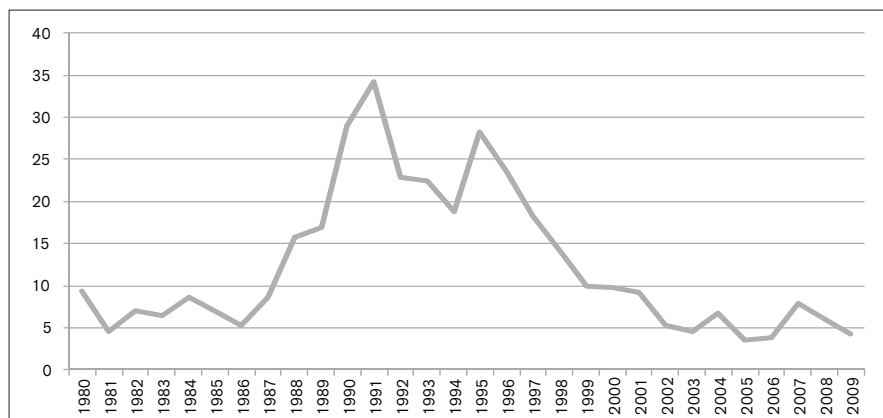
Source: EBRD (2007).

11.6.3 Inflation

Inflation was relatively low in Hungary during the first transformation decade. An important part of the goods in the consumers' baskets had been liberalized before 1990 and thus Hungarian politicians did not have to carry out instant price liberalization. But Hungarian inflation was comparatively high during the following years. It was partly caused by the monetization. Decline in inflation can be seen only at the end of the 1990s. Even then con-

sumer prices increased more than 5 percent per year. The arithmetic average for the period between 1990 and 2003 reached nearly 18 percent (IMF 2010).

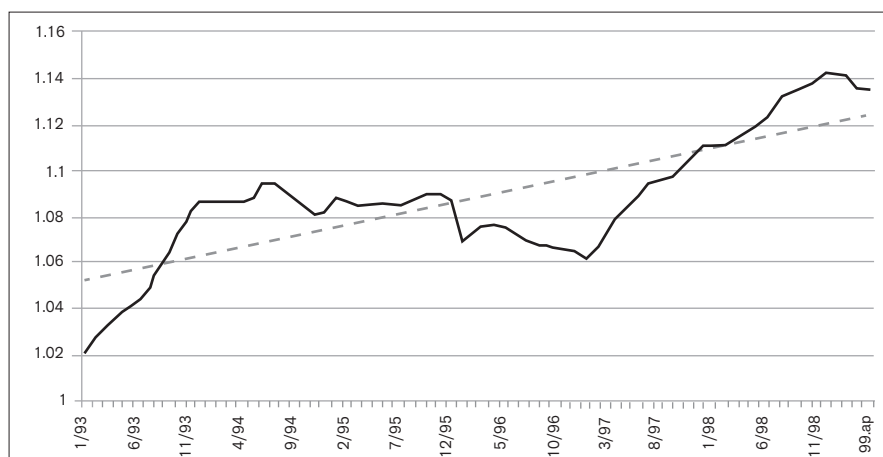
Figure 11.8: Inflation, average consumer prices, 1980–2004 (percentage change)



Source: IMF (2010).

In accordance with expectations and economic theory of the Balassa-Samuelson effect, the prices went up more for nontradable goods and services during the transformation period. We can see an estimation of the price development of tradable and nontradable goods in Figure 11.9.

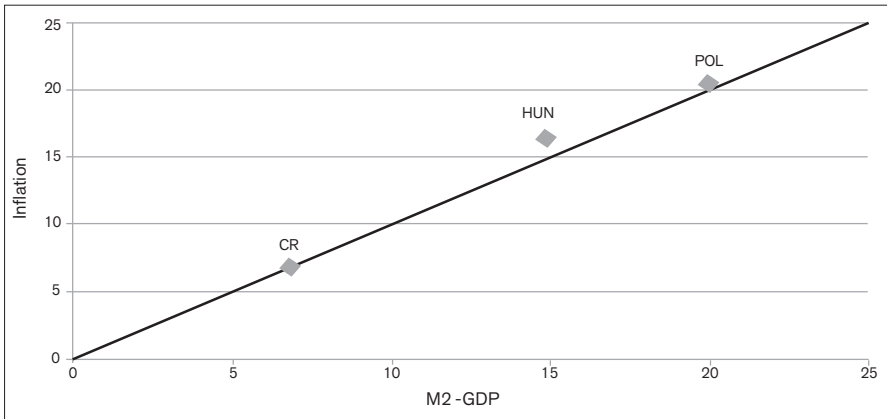
Figure 11.9: Nontradable/tradable inflation in Hungary (1991=1)



Source: Halpern and Neményi (2001).

Generally, economic rules are valid for transformation countries as well as for well functioning market economies. Figure 11.10 depicts a connection between inflation and growth of money supply. We can see a nearly textbook relationship, in which countries with a higher difference between growth of money and growth of GDP have higher inflation. This development had an impact on the exchange rate regime and interest rates.

Figure 11.10: Inflation (average percentage change of CPI) and growth of broad money minus growth of real GDP, 1993–2004 (in %)

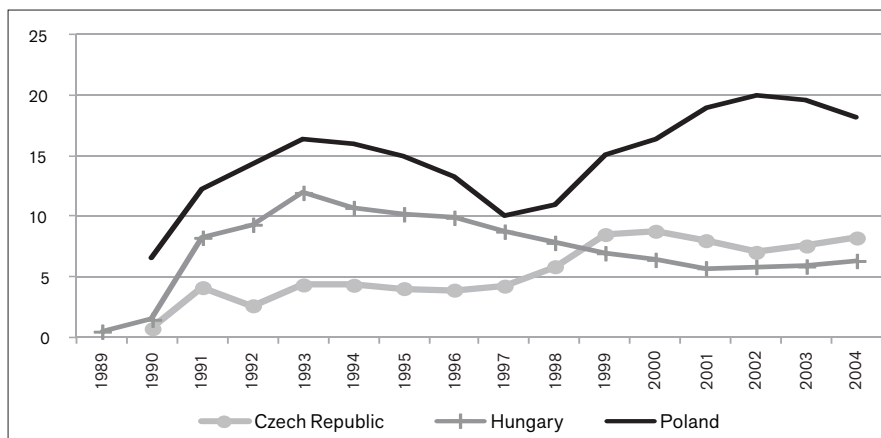


Source: EBRD (2007).

11.6.4 Unemployment

Hungary did not avoid growth in unemployment in the first years of transformation even if the country followed a more gradual approach. Within several years unemployment achieved its maximum—around 12 percent of the labor force. After that it began to gradually decline. We can see the contrast to the development in the Czech Republic where unemployment rate was minimal until 1997 and grew only with the currency and economic crises in 1997. At that time Hungarian unemployment rate was already steadily declining. I should stress that unemployment rate was in both of these countries very low in comparison to other postcommunist countries; Poland is one such example (see Figure 11.11). By contrast, there was a sharp decline in employment in Hungary and thus the numbers are affected by it.

Figure 11.11: Unemployment rate 1989–2004 (% of labor force)



Source: EBRD (2007).

11.6.5 External relationships

Hungary was relatively mildly affected by disintegration of the Council for Mutual Economic Assistance. Hungarian exports declined by roughly one-quarter, which was much less than in some other countries (see Table 6.1). The country generally followed the path to liberalization of international trade as did the other countries of the Eastern Bloc. In 1990, tariffs declined and quotas on consumption goods were abolished. Hungarian trade quickly reorientated toward western markets. EU-15 created 34 percent of Hungarian exports already in 1989. This number rapidly increased to 50 percent in 1991 and 70 percent in 1997. There was a growing role of goods in the exports into the EU as well—from 55 percent in 1989 to 85 percent in 1997 (Stojanov 2004). Germany became Hungary's main trading partner, as it did with other Central European countries (see Table 11.18).

Overall, the Hungarian economy firmly integrated into the world economy as we can see from Figure 11.12. The share of exports and imports to GDP increased from 60 percent in the first half of the 1990s to more than 160 percent before the last economic crisis in 2008.

I have already mentioned Hungarian problems with the current account in the middle of the decade. The Bokros package solved these problems but in the twenty-first century the imbalance started to grow again. These

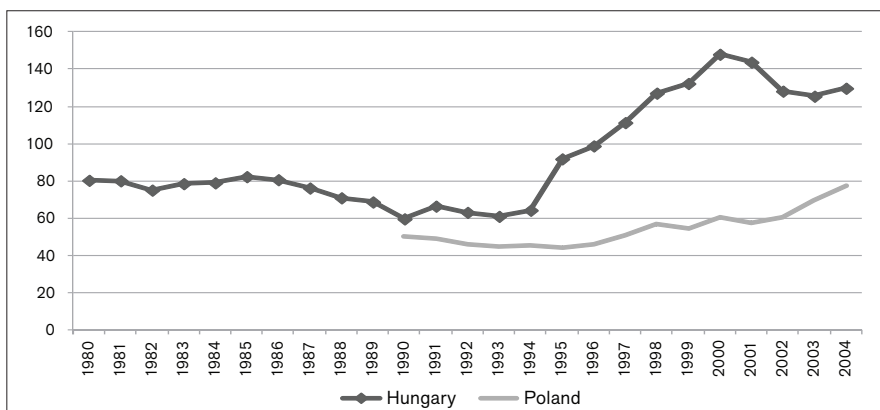
problems were not deemed as severe as in the mid-1990s but contributed to currency problems during the world economic crisis at the end of the first decade of the twenty-first century.

Table 11.18: Share of the main trading partners in 2003 (in %)

Imports	% share	Exports	% share
Germany	24.5	Germany	33.9
Italy	7.1	Austria	8.1
China	6.9	Italy	5.8
Austria	6.3	France	5.8
Russia	6.2	United Kingdom	4.6
France	4.8	The Netherlands	4.1
Japan	4.2	United States	3.1
United States	3.2	Poland	2.3
Poland	2.8	Czech Republic	2.1
United Kingdom	2.7	Slovakia	2
Czech Republic	2.4	Russia	1.5
The Netherlands	2.2	Japan	0.7
Slovakia	1.9	China	0.4

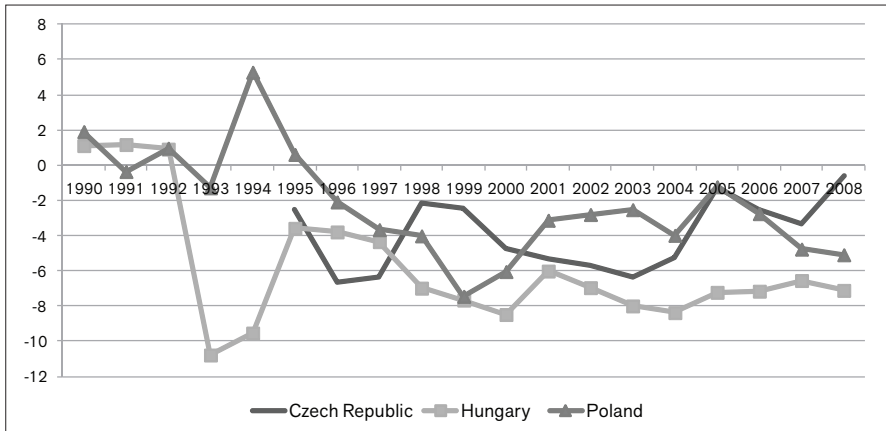
Source: Hungarian Central Statistical Office (2010).

Figure 11.12: Exports and imports in Hungary and Poland (% of GDP)



Source: The World Bank (2010).

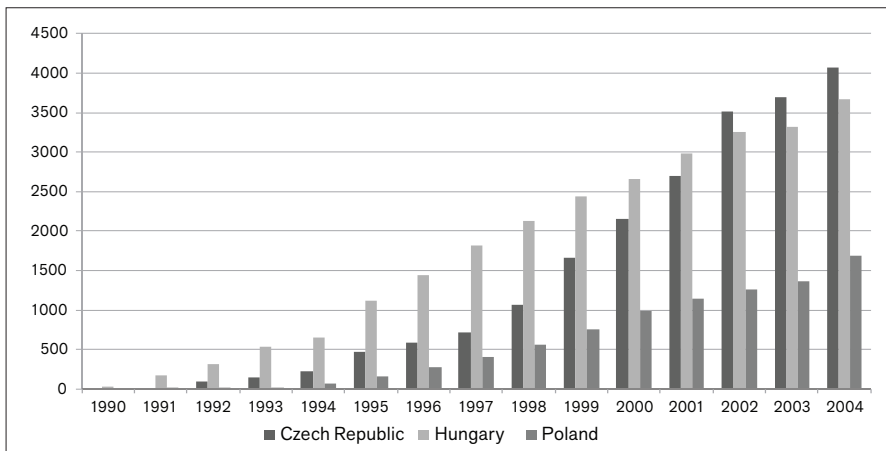
Figure 11.13: Current account to GDP, 1990–2008 (%)



Source: IMF (2010).

The second aspect of international relations that I would like to discuss is the inflow of foreign direct investment. I have already mentioned that Hungary had good starting position in this field because of its advance during the 1980s. This led to relatively high inflow of FDI in the first years of the transformation and Hungary was one of the leaders among the postcommunist countries (see Figure 11.14).

Figure 11.14: Cumulative FDI inflows per capita, 1990–2004 (in USD)



* –there are no data for the Czech Republic in 1990 and 1991 and for Poland in 1990

Source: EBRD (2007).

Economic problems in the middle of the first decade of the transformation resulted in increasing privatization effort and installing of investment stimulus. These measures helped to even higher FDI inflow in the second half of the 1990s. The comparison with the CR can be seen in Table 11.19.

Table 11.19: FDI in the Czech Republic and Hungary, 1990–2000 (in USD per person)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
HUN	30	141	142	227	112	435	223	214	201	196	196
CR	13	50	97	63	84	248	138	126	361	615	447

Source: Srholec (2001).

The role of foreign entities in Hungarian economy was generally growing. The main investors came from Germany and the United States. Companies with foreign capital generated 47 percent of all sales, 29 percent of employment, and 60 percent of exports back in 1996. The exports figure increased to 73 percent in 1997 (Berend 2009). The importance of the foreign companies in Hungary and other Central European countries can be seen in Table 11.20. Stock of FDI corresponded to one-third of Hungarian GDP in 1998 (Stojanov 2004).

Table 11.20: Share of foreign companies
in production of the industrial sector at the end of the 1990s

	Employment	Investment	Sales	Exports
Czech Republic	27	53	42	61
Hungary	47	82	73	89
Poland	29	63	49	59

Source: Berend (2009).

This chapter has demonstrated that Hungarian development was not straightforward. The country suffered from transformation recession just as the other countries of the Eastern Bloc even if its starting conditions were significantly better in some fields. The half-hearted economic reforms in the first years of the transformation led to economic imbalance that was solved by tough economic measures in the form of the Bokros package. Overall, Hungary achieved great results during this period that were proved by the admission to the EU in 2004. GDP per person nearly doubled during the

transformation period. The ability of the economy to grow improved and the trend was positive, contrary to the previous period. The Hungarian economy was able to catch up with the developed countries. Most of the other economic indicators developed positively as well. And the companies were able to stand up to competitive pressures in the EU. It is thus surprising that Hungarian did not see these positive results and according to the public surveys were dissatisfied with their economic situation in the middle of the first decade of the twenty-first century.

Notes

- ¹ Multiple exchange rates were common in centrally planned economies. They created distortion and malfunctioning of the system. Unifying exchange rate was a step in the direction towards an ordinary economic system.
- ² EBRD has a basket of fifteen basic consumption goods. The statistics says that in 1989, prices of only seven of the fifteen goods were administrated by the government. The corresponded number for Poland was ten and for the Czech Republic fifteen (EBRD 2007).
- ³ There are older surveys that detect the same attitude of the Hungarians. The conclusion is that their view was not affected by the financial crisis.
- ⁴ Overall Hungarian progress was supported by foreign funds in the form of Poland and Hungary Aid for Economic Restructuring (PHARE) since the fall of 1989.
- ⁵ In Hungary there was not even an approved new constitution—contrary to the surrounding countries—until 2011, but only amendments.
- ⁶ Hungary followed a path of irregular devaluations of the exchange rate since 1990 to keep the real exchange rate roughly stable. The currency was devaluated three times in 1990 but together only by 5 percent; twice in 1991 (together 21 percent); three times in 1992 (together 6 percent); five times during 1993 (together 15 percent); and seven times during 1994 (together 17 percent) (Magyar Nemzeti Bank 2010).
- ⁷ The crawling peg system is based on small devaluations of the currency on the regular (usually monthly) basis. The central bank decided on devaluation of 1.9 percent per month since the spring of 1995. The rate of devaluation declined in the following years to 0.6 percent per month since January 1, 1999; 0.3 percent since January 1, 2000; and 0.2 percent since April 1, 2001 (Magyar Nemzeti Bank 2010).

TRANSFORMATION IN POLAND¹

This chapter analyzes economic development in Poland during the transformation period and compares it with economic development in the Czech Republic. I first concentrate on the political development during the communist period in order to understand better the initial political and economic conditions in the country. The same objective is pursued in Chapter 12.2, which describes the state of the Polish economy at the end of the 1980s. These two parts should help the reader to understand the extent of the goal to transform the economy from centrally planned to market system. In the following subchapters I shortly describe political development during the transformation period as politics played a crucial role in determining economic measures, and I follow Poland through the transformation period up to the country's admission to the EU in 2004. The main part of the text is dedicated to economic reforms applied in the country after 1990. I concentrate on privatization and the development of the banking sector in the separate subchapters. Economic results are analysed in the last subchapter. We will see the development of the main economic indicators—among others economic growth, unemployment, inflation and external relationships.

Generally, I proceed in the structure from the situation at the beginning of the transformation process, via the economic policy that was applied by the reformers to the economic results that were achieved during the transformation period.

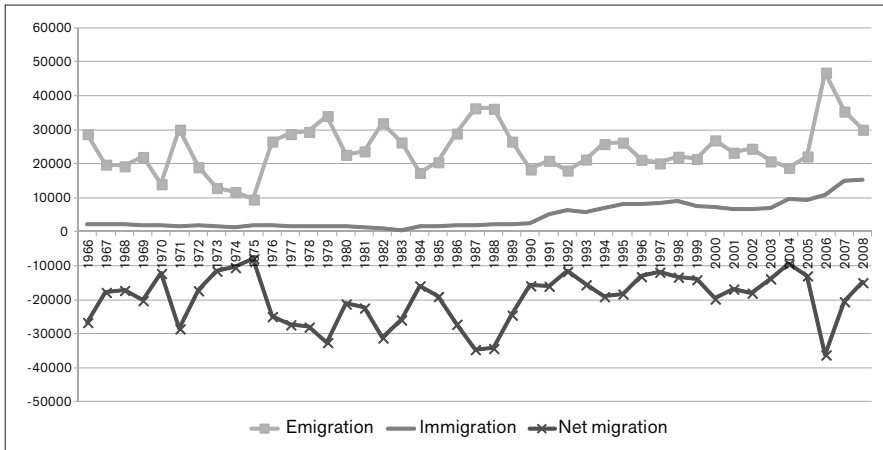
12.1 Long-term political development

Poland became part of the communist bloc after World War II. But Polish relationship with Russia and later the Soviet Union was always prickly and it determined the attitude toward socialism in the country.² The first step on the way to total Russian domination was the fact that the Polish postwar government was created from the exile government situated in Russia, while the exile government in the UK was ignored. Later on, Polish communists (Polish Workers' Party; PPR, which in 1948 united with Polish Socialist Party, PPS, and became Polish United Workers' Party, PUWP) rigged elections in 1947 and took over the power.

The communist regime was not without problems. The first mass uprisings took place in Poznan already in 1956. The protests were triggered by the lack of foodstuff and consumption goods, decline in real incomes, and overall poor economic situation. However, these protests were suppressed. In 1956, Wladyslaw Gomulka (1905–82) became the leader of the PUWP. He proposed a program of economic reforms. The Soviet Union did not agree with the steps and even threatened Poland with military action. Later on, the situation calmed down and Gomulka proceeded with the reforms and his reign is nicknamed as Gomulka's thaw. But the economic situation did not improve and there was another wave of riots and strikes in 1970, which were bloodily suppressed and led to Gomulka's resignation. Eventually, he was replaced by Edward Gierek (1913–2001) in 1970. Gierek promised economic reforms, improvement in industry, and overall uplift of Polish economic situation. Gierek was able to convince western politicians to provide aid and loans to Poland. But the country suffered from growing prices, food shortages, and increasing foreign debts. In 1978 John Paul II was elected a new pope; he soon became the symbol of Polish opposition against the communist regime. The lack of basic freedoms and inferior economic conditions resulted in high numbers of people that left Poland during the communist reign (see Figure 12.1). Between 1966 and 1989 nearly 600,000 Polish inhabitants left the country.

The government decided in favor of another round of economic reforms and among others increased prices in 1980. This step led once again to protests. This time, the protests were centered in shipyards in Gdansk and Szczecin, where a Polish trade union named Solidarity was formed. Lech Walesa (1943–) became the leader of the trade unions. During the riots, Gierek was forced to resign.

Figure 12.1: Emigration, immigration, and net migration in Poland, 1966–2008



Source: GUS (2010).

General Wojciech Jaruzelski (1923–2014) took power in 1981 after a short reign of Stanisław Kania. He proclaimed martial law with the main goal to suppress the Solidarity movement. The trade unions were moved to illegality and the leaders put to jail. Wałęsa was awarded the Nobel Peace Prize in 1983. The conflict between the communist government and the opposition lasted until the beginning of 1989 when a new surge of huge strikes forced the government to accept Solidarity.

12.2 Economic situation

The centrally planned system was introduced in Poland after World War II. The country was relatively backward with a large part of GDP created in agriculture. The farmers were forced into cooperatives similarly to other countries of the Eastern Bloc. However, a relatively high proportion was allowed to remain in private hands or returned to private owners already in the 1950s. This was a significant and important difference compared to Czechoslovakia. Economic reforms were applied during the political melting in the 1960s and the 1970s. For example Poland signed GATT agreement in 1967. During the 1970s Polish government borrowed huge amounts of money from abroad, which led to growing foreign debt. Since 1976, the country offered legal envi-

ronment for foreign direct investment. Generally, Gierek hoped to increase economic growth by a huge investment wave. During the first half of the 1970s investment really increased by 133 percent and GNP by 29 percent (Berend 2009). However, this development did not lead to improvement in the structure or technological level of the economy; it was directed mostly into the backward industries. As a consequence, investment mostly resulted in overheating of the economy and continuous inflationary pressures.

The economic situation sharply worsened with the start of the global debt crisis in 1980. Poland was one of many affected developing countries at that time. Polish GDP declined by 10 percent between 1978 and 1983. This economic crisis brought about lack of foodstuff and consumption goods and led to a wave of riots connected with the founding of the Solidarity movement. The government deficit reached 8 percent of GDP at the end of 1980 (Watanabe 2002). In 1982, the country was not able to pay its debts, thus suffering from the deficit of balance of payment and monetary excess in the following years as well (for more on foreign debt, see Table 11.2).

The martial law did not succeed in stabilizing the economic situation. There was continuous lack of basic products during the 1980s. Economic results were worsening despite steps toward economic rationalization; Poland, for example introduced a bankruptcy law in 1983, a two-tier banking system in 1988, and made it possible to start small businesses for foreigners with Polish roots in the 1970s. Table 12.1 depicts the main reform steps.

Table 12.1: Chronology of reform measures before 1990

Reform measure	Hungary	Poland	Czechoslovakia
Cancellation of obligatory plans	1968	1982	1990
Cancellation of centralized quotas	1968	1991	1990
First steps leading to liberalization of prices	1968	1957, 1975	1991
Unified exchange rate	1981	1990	1991
Admission to IMF and WB	1982	1986	1990
Free private enterprises	1982	No restrictions	1991
Bankruptcy law	1986	1983	1991, 1992
Two-stage banking system	1987	1988	1990
New income tax system	1988	1992	1993
VAT system	1988	1993	1991 [<i>sic</i>]
Corporate law	1989	1990	1991
Trade liberalization	1989	1990	1991
Unemployment benefit system	1989	1990	1991

Source: Kornai (1996).

The country was hit by another crisis in 1987, which resulted in growing shortage of foodstuff and consumption goods. The government once again partly liberalized prices, which led to growing inflationary pressures. This indicator reached 640 percent in the fall of 1989, while the average yearly increase in prices in the 1980s was 60 percent. Overall we can say that economic policy in Poland was chaotic. Another example of economic distortions was the exchange rate (see Table 12.2). The difference between the official exchange rate and the exchange rate on the black market was enormous.

Table 12.2: Exchange rates to USD (averages in units of national currency)

	1988	1989	1990	1991
Czechoslovakia				
Official	14.36	15.05	17.39	29.48
Unofficial	33.44	43.39	(39.0–40.0)	32.28
Hungary				
Official	50	59	63	74
Unofficial	.	.	.	.
Poland				
Official	431	1,446	9,500	10,559
Unofficial	1,979	5,665	9,570	10,731

Source: Winiecki (1993).

Economic results were partly caused by specific Polish self-managed socialism. This system was generally similar to the system in Yugoslavia. The main idea was that companies controlled by workers should function in a better way. It was hoped that the motivation of the employees should increase and it should improve overall efficiency. The system was introduced under pressure by Solidarity in 1981 with a new Act on State Enterprises. According to this act, self-governing councils were established in all companies, with the exception of military and strategic production. The councils were elected by plenary meeting of all employees for two-year periods. They were enormously powerful—they had the right to appoint and dismiss directors, control the directors' activities, exercise the veto privilege over all important decisions, accept production plans, and so on. The councils had the right to decide about the liquidation of the company as well. In reality, the impact of the system on companies is generally deemed as negative. The employees imposed pressure on the management to increase wages in excessive ways, which would add to inflationary pressures (Holman 2000). The two countries that foremost

used this system—Poland and Yugoslavia—suffered from high inflation. The employees were (of course) against any rationalization of production connected with dismissal of workers; the system also did not improve the employees' motivation (Holman 2000).

Another problem of the Polish economy was the overall ownership structure. State companies and cooperatives created 81.9 percent of GDP in 1988 and the private sector made 18.1 percent but without agriculture the number was only 7.6 percent of GDP (Wang Zhen 1991). The long-term development of the state and private share is depicted in Table 12.3. We should notice that the share of the private sector was growing since the end of the 1970s and for example handicraft production was mostly private (Gabrisch and Hölscher 2006). Overall, the Polish private sector was significantly larger than in Czechoslovakia.

Table 12.3: Share of nationalized and private sectors in industrial production in Poland

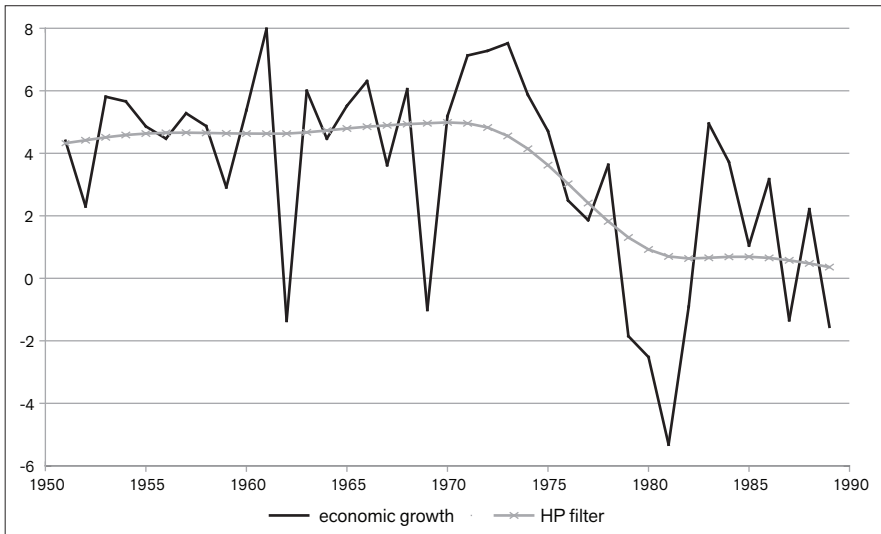
Year	Share of the nationalized sector	Share of private sector
1977	98.22	1.78
1980	97.54	2.46
1985	95.49	4.51
1989	93.4	6.6
1990	91.2	8.8

Source: Wang Zhen (1991).

The structure of the Polish economy represented another problem. The share of agriculture in GDP and employment was very high (see Table 11.4). It was a proof of relative underdevelopment of the economy. Another obstacle to the transformation process was armament production, which represented a relatively high (2.5 percent) proportion of the industrial production. In the 1980s Poland was among ten biggest producers of weapons, following Czechoslovakia. Two-thirds of the weapons were produced for the Warsaw Pact countries, primarily for the Soviet Union (Szayna 1995).

There were economic problems already in the 1960s. After the previous analysis of economic policy, we should not be surprised that long-term economic results extremely worsened in the second half of the 1970s. Economic growth declined to zero and stayed close to it in the following decade (average growth was only 0.35 percent [Maddison 2010]). Figure 12.2 shows both the sharp declines and the overall trend.

Figure 12.2: Economic growth and long-term trend (by HP filter) in Poland, 1950–1989 (in %)

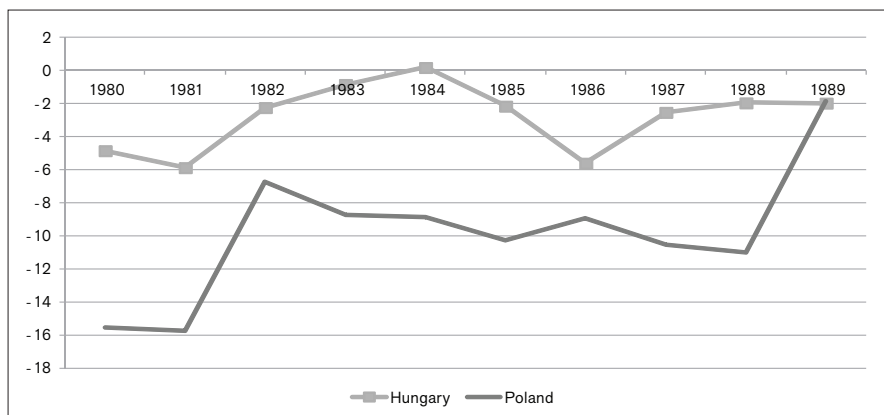


Source: Maddison (2010).

Poland had problems with inflation pressures in the 1980s. The main culprit was monetary excess, which was connected with financing of the governments' deficits. Another source was a continuous pressure on growth in wages, which was not balanced by growth in productivity. The government responded by regulating wages and prices. These measures led to general imbalance on the markets and lack of goods and emergence of the black market. In other words, there was a surplus of aggregate demand over supply. Regulated prices meant that part of the inflation pressures stayed suppressed, and surfaced only after price liberalization. There were similar problems in other economies—Hungary and Czechoslovakia—but in Poland the situation was significantly worse.

Another huge problem was connected to the current account. We can see the development of this indicator in Figure 12.3. The economy was relatively closed too—it had a lower volume of trade than Czechoslovakia in 1989 even if the size of the economy was bigger and the Czechoslovak economy was relatively closed too (Lavigne 1999). Foreign investment in the country was highly limited at this time. According to UNCTAD, FDI stocks reached only 0.2 percent as percentage of GDP (UNCTAD 2006).

Figure 12.3: Current account balance (% of GDP)



Source: IMF (2010).

In our discussion of Poland's economic development I have omitted the economic steps that were taken in 1989 when Rakowski government introduced a reform program. The program included liberalization of foreign exchange transactions; equal conditions for different types of ownership and opened ways for privatization of state-owned companies; reduced subsidies on a large number of consumers' products, especially food; and closed inefficient plants or incentives for foreign investors (Watanabe 2002). Kolodko writes about price liberalization that took place in August 1989. It resulted in hyperinflation but it did not end the shortage of goods in Polish stores (Kolodko 1991). Further, there were two devaluations of zloty in the fall of 1989. We can conclude that economic reforms as a consequence did not have to start from the scratch.

12.3 Political development during the transformation

Weak economic situation led to a point when the Communist Party was forced to accept negotiations with the Solidarity movement in 1989. The result of the round-table negotiations was a pseudo-democratic system that was expected to last for four to six years. Part of the agreement was a promise to organize elections in June 1989. The elections were only partly free but Solidarity achieved great victory that resulted in a situation when this political

force de facto took power. In September 1989 Poland finally had its first noncommunist government. Some think that the change was so quick that Solidarity was completely unprepared for it (e.g., Orenstein 2001). Regardless, the support for the government was high—75 percent. Walesa was elected president at the end of the year.

The first entirely free elections took place in 1991. By that time, Solidarity had split into several fractions. The economic development was one of the causes of the split because there were constant disputes about the radical economic reform. Transformation decline was more severe than had been expected. The proportional electoral system resulted in twenty-nine political parties in the parliament. No party gained more than 13 percent of the votes. The political situation was fragile and all coalition governments were weak and changed several times. There were other disputes inside Solidarity. The first steps toward European integration were made by signing the associate agreement in 1991. New constitution was approved in 1992 and it codified a more influential role of the president.

Protests took place during the whole period since the start of the reforms but the summer of 1992 was exceptionally turbulent, leading to early elections in 1993. The elections were won by left-wing parties with the Democratic Left Alliance—successor of the Communist Party—as the winner. The new government generally continued with the transformation process but at a slower pace and it also put more emphasis on social aspects. The leader of the Democratic Left Alliance Aleksander Kwasniewski (1954–) defeated Lech Walesa in the following presidential elections in 1995 and became the head of the state for the next ten years.

The next parliamentary elections in 1997 were won by right-wing parties unified in the Solidarity Electoral Action. It was a heterogeneous bloc of forty political groups. They joined against the left but it was difficult for them to find uniform position when they governed the country. Despite this, the government was able to take unpopular steps leading to further decline of its popularity and its eventual collapse in 2000. Meanwhile Poland became a member of NATO in 1999. The country was run by a minority government until the next elections in 2001. These were again won by a landslide by the Democratic Left Alliance. The party created a coalition together with the Polish People's Party. But this coalition broke down in 2003 and the country was ruled until the next elections by a semiclerical government. Poland became a member of the EU in 2004.

Frequent elections and changes of government show that political situation in Poland was rather unstable, which was similar to other postcommunist countries. The governments changed quickly—there were ten prime ministers in Poland between 1990 and 2004—and they were often not able to survive even one election period regardless of positive or negative economic results.

12.4 Basis of economic transformation

Poland was affected by the same discussions about the overall direction of its economic transformation as other countries. The opinions varied from gradualism to shock therapy. The difference was that in the Polish economic situation that was much worse than in Hungary or Czechoslovakia. The situation was in fact close to being catastrophic—hyperinflation, budget deficit, huge foreigner debt, large money excess, and deficit of the current account. The situation was critical and Polish economists recognized it as such. It is not surprising then that they decided to solve this situation by quick measures—in other words by shock therapy or “Big Bang” reform.

Table 12.4: Percentage of people that deemed the topic as highly important or important (survey carried out between November 1990 and August 1991)

	Hungary	Poland	Czecho- slovakia
Who should cover medical expenses			
Treated persons	14	27	18
Government	86	61	82
It is necessary to restrict personal earnings			
No	41	82	80
Yes	59	15	20
Do you deem differences among the rich and the poor as an important problem?	64	64	70
Do you think that capitalist economy based on free initiative is the best for your country?	71	78	67
Do you consider the following to be the government's task (answers: yes and probably yes)			
Find everybody a job	71	62	57
Carry medical costs of the ill	87	66	78
Secure living standards for old people	90	65	80
Reduce differences among incomes of rich and poor people	57	26	40

Source: Kende (1993).

The mood in the country was overall favorable toward a change and toward a market economy but the view can be different if we consider specific attitudes of the inhabitants. The results of a broad public opinion survey can be seen in Table 12.4. We can see from the table that the attitudes in Poland—as well as in other countries—can be described as socialist or at minimum left wing. We can attribute this to the general lack of knowledge about the function of market economies because it seems that people desired the best from both systems. There were high expectations connected with the introduction of market economy that most of the people deemed to be the best. But at the same time, the very same people thought that governments should maintain a leading role in the society and preserve the advantages of the former system.

12.4.1 The Balcerowicz plan and the development that followed

The shock therapy plan in Poland is connected with the name of Leszek Balcerowicz (1947–), who was the minister of finance in the first Solidarity government.³ I should stress that the reformers tried to stay out of politics, and remain just technocrats, but they depended on the support of politicians (Orenstein 2001). Another important person for Polish transformation is a well-known American economist Jeffrey Sachs (1954–) who was the key economic adviser to the Polish government.

Poland started its reforms as the first country of the Eastern Bloc at the beginning of 1990; its progress had as a consequence an impact on the transformation process in other countries—for example in Czechoslovakia. The reformers decided to shift the economy into a market environment by liberalization and parallel stabilization as soon as possible. The reform program contained immediate liberalization of markets, including price liberalization and inner convertibility of the zloty. The convertibility was broader than in Czechoslovakia because the market agents were able to have accounts in dollars and as of June 1991 it was possible to repatriate wages and profits (Winiecki 1993). The currency was deeply devaluated (43 percent) and fixed to the dollar (see Table 12.2). It was expected that the central bank would be able to keep this exchange rate only for three to four months (Nutti 2000). The Polish government received USD 1 billion in the form of a stabilization fund from G-24 and a bridging loan from the Bank for International Settlements

(USD 215 million). The purpose of this capital was to support trust in the currency. The load did not have to be used. At the same time the government tried to restrain the growth of wages—increase above set limit was heavily taxed. To be more specific, the tax on income ranged from 200 percent to 500 percent in case the growth of wages overcame predetermined indexation coefficient linked to inflation (Watanabe 2002).⁴ But the tripartite was able to increase wages later on.

The cabinet tried to apply fiscal restrictions too, with the intention to diminish the government deficit from the previous year. The main way to achieve this task was via limiting subventions (Watanabe 2002). They declined from one-third to one-fifth of the budget between 1989 and 1990 (Kolodko 1991). The sharp decline in subsidies can be seen in Table 12.5. Privatization was not part of the first reform package and was planned to start later on.⁵ This was probably the toughest shock therapy approach in the whole Eastern Bloc (Holman 2000). Nevertheless, inflation pressure was high as a consequence of dismantling of the monetary excess; in fact, it was much higher than expected and higher than in Czechoslovakia, mainly because of the previous massive imbalances in the Polish economy (Kolodko 1991).

Table 12.5: Change in relative size of subsidies (% of GDP)

	1988	1989	1990	1991
Czechoslovakia	13.0	16.0	12.1	7.0
Hungary	13.4	9.1	8.4	6.0
Poland	13.5	9.6	6.7	2.4

Source: Winiecki (1993).

The country suffered from transformation recession as well but there was not a single case of bankruptcy. Nominal wages increased but the wage regulation helped to keep real wages low—the overall decline of real wages reached 30 percent in 1990 (Watanabe 2002). Another problem was growth of unemployment—it sharply and quickly increased from 0.1 percent in 1989 to 6 percent at the end of 1990 and 11.8 percent in 1991. It meant nearly 100,000 newly unemployed people every month. Support for Solidarity declined to 55 percent already in the mid-1990 (Orenstein 2001). Conversely, the government was able to keep the public finance in surplus in 1990. See Table 12.6 for the development of the main economic indicators.

Table 12.6: Development of the main economic indicators in Poland, 1990–1993

	1990	1991	1992	1993
Real GDP	-11.6	-7	2.6	3.8
Inflation (CPI)	585.8	59.4	45.3	36.9
Unemployment	6.5	11.8	13.6	16.4
Public budgets (% of GDP)	0.7	-6.4	-6	-2.8

Source: Holman (2000).

There were foreign causes of the Polish economic troubles as well. The main culprit was the disintegration of the Eastern markets. International trade with the Soviet Union declined by 90 percent between 1990 and 1991, only several years before the country purchased between 30 and 40 percent of Polish exports (Bienkowski 1995). Decline in trade with the Soviet Union was a symptom of general decline of trade with the CMEA countries. The export of weapons for example slumped to 5 percent of the 1987 level in 1987 (Szayna 1995). Conversely, Poland received a huge support from Western countries. This support started in the fall of 1989 when the PHARE program was created. In April 1991, 50 percent of Polish debts were remitted; the United States for example wrote off 70 percent of the Polish debt and the rest in 1993 (Berend 2009). The IMF helped to create a stabilization program and lent Poland money (Berend 2009). Still, Poland exceeded the limit for deficit of the public finance in 1991 and the IMF suspended the standby credit. Monetary policy was restrictive in the first years of the transformation and not surprisingly used mostly administrative instruments—credit ceilings and reserve requirement.

The central bank was able to defend the exchange rate until May 1991 even if there was growing deficit of the current account since the last quarter of 1990. The zloty was in May 1991 devaluated by 17 percent and it was fixed to a basket of five currencies instead of US dollar only (45 percent of USD, 35 percent of DM, 10 percent of GBP, 5 percent of FRF, 5 percent of CHF). In October the exchange rate system was changed to a crawling peg (1.8 percent devaluation per month) with narrow band (± 1 percent). There were bigger devaluations in 1992 and 1993 (12 percent and 8 percent). The cause was the real appreciation of the currency; in other words the exchange rate pillow quickly disappeared due to a relatively high inflation in the country. The periodic monthly devaluations declined to 1.2 percent in 1995. The crawling peg helped to stabilize the real exchange rate in the first years of the transformation (see Figure 11.3), but it created inflation at the same time.

Economic conditions in 1993 were rather poor—there was still inflation of 37 percent, 16.5 percent of the labor force was without jobs, and there were deficits of public finance and the current account. The radical economic reform and its impact shaped the public opinion and as a consequence, a postcommunist left-wing party won the elections in 1993. The new government came with a program called Strategy for Poland. The author was the Minister of Finance Grzegorz Kolodko (1949–). The program generally kept the main direction of the transformation process but put more emphasis on social aspects. The government supported a higher role of the state and negotiations with pressure groups—primarily trade unions. The goal was economic growth and improvements in living standards. Table 12.7 shows that the program did not have any impact on inequality in the society. The Gini coefficient stayed relatively stable after a sharp rise at the beginning of the transformation process.

Table 12.7: Development of the Gini coefficient, 1994–2004

	Czech Republic	Hungary	Poland		Czech Republic	Hungary	Poland
1989	19.3	21.3	25.0	1998	22.6	24.3	32.6
1990	19.7		26.8	1999	23.8	23.7	33.1
1991		20.3	23.2	2000	23.8	25.0	34.2
1992	20.3		24.0	2001	22.8	25.7	34.0
1993	21.5	22.6	31.5	2002	23.2	24.6	34.9
1994	22.0	23.0	32.6	2003	22.8	25.2	35.2
1995	21.5	24.3	32.2	2004	23.5	27.4	36.6
1996	22.9	24.4	32.9	2005	25.8	27.9	36.6
1997	22.6	24.5	34.0	2006	24.2	26.2	

The coefficient ranges between 0 and 100 with higher numbers means higher inequality.

Source: United Nations University (2010).

A relatively high economic growth helped the government to keep budget deficit under control (see Figure 11.2). Monetary policy increased the role of the market instruments after 1993 with targeting money in circulation. This policy came under pressure with massive capital inflows after 1995. In 1994 Poland made agreement with the Paris and London creditors clubs. These agreements led to normalization of relationship with the world financial markets after a fifteen-year pause. In January 1995, the zloty was redenominated as a consequence of previous high inflation. The currency got rid of

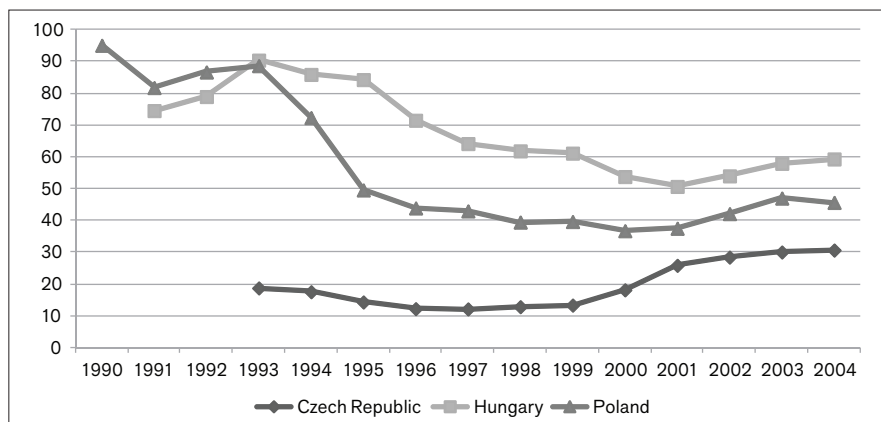
four zeros, meaning that 10,000 old zloty (PLZ) was exchanged for 1 new zloty (PLN). Poland liberalized transactions on the financial account, which meant that the currency became fully convertible, and the country became a member of the OECD in 1996. The central bank decided to increase the fluctuation zone of the zloty up to ± 7 percent in May 1995. Liberalization of capital movement led to strong inflow of capital into the country and appreciation pressures. The central bank responded with interventions on the exchange rate markets and purchasing of foreign currencies. In December the zloty was appreciated by 6 percent. Foreign reserves increased from USD 5.8 billion to USD 15 billion during the year as a consequence of the central bank effort to keep the exchange rate. In the following years, periodic devaluation of the crawling peg system diminished, the fluctuation zone widened to ± 15 in 1999, and the basket was limited to just two currencies (45 percent of USD and 55 percent of euro) (Watanabe 2002).

The economic development in the first half of the 1990s was characterized by the declining role of the government. The share of government expenditures in GDP went down from 72 percent in 1989 to 45 percent in 1995 (Tomšík 1996). The government decided to implement another reform package in 1996, called Package 2000. The main goal of the reform package was improvement of the public finance, decline in inflation and unemployment. The main tool was a change in the tax system. Changes were implemented in healthcare, education, and pension systems after 1997 as well (Orenstein 2001). The principal reform took place in the pension system in 1999. The main characteristic of the system was that there were three pillars—the first was based on pay as you go but with individual accounts in management of a public institution. The second was in the form of private funds with 40 percent of the levy going into these funds. And the third was voluntary. The overall pension fully depended on the size of the insurance.

The economy started to have problems with outer balance. It suffered from a relatively high trade deficit in the last years of the twentieth century, and there was undoubtedly a negative impact of the currency crisis in Russia in 1998.

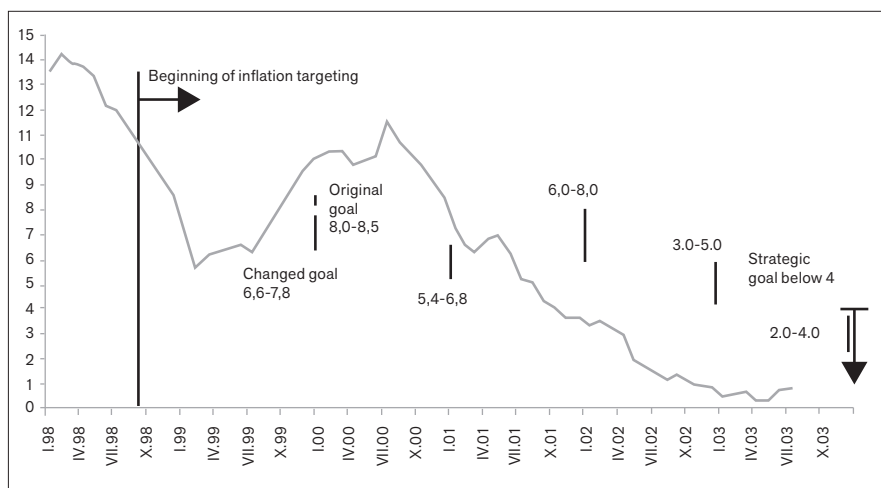
The government mostly applied restrictive fiscal policy in the following years. It helped to decline public debt as can be seen from Figure 12.4. The figure shows that Poland as well as Hungary improved their public finance after 1993 and in both countries—contrary to the Czech Republic—public debt was declining until the beginning of the twenty-first century.

Figure 12.4: Public debt in Central Europe, 1990–2004 (% of GDP)



Source: EBRD (2007).

Figure 12.5: Inflation and inflation targeting in Poland, 1998–2003



Source: Newton (2003).

There were more changes in economic policy around the turn of the century. In 1999 the central bank decided in favor of inflation targeting. The Monetary Policy Council defined the inflation target and then adjusted the national bank basic interest rates. The central bank had problems achieving the goals in the first years (see Figure 12.5). But the problems were different compared

to the CNB, with the Polish central bank both overshooting and undershooting its target. Since the beginning of 2004, the National Bank of Poland has pursued a continuous inflation target at the level of 2.5 percent with a permissible fluctuation band of ± 1 percentage point. Since April 2000 the zloty exchange rate has been in the system of free floating and it has not been subject to any restrictions until 2015.

Positive trends in the fiscal sphere were reversed after 2000. The Polish governments had growing problems with fiscal discipline which led to growth in government debt (see Figure 12.4). The problems had structural character as we can see from Table 12.8.

Table 12.8: General government balance and government structural balance, 1998–2004
(% of GDP)

	1998	1999	2000	2001	2002	2003	2004
Government balance	-3.2	-3.3	-3.3	-5.2	-6.1	-5.6	-5.9
Structural balance	-4.4	-4.4	-4.1	-4.8	-4.7	-4.5	-5.2

Source: IMF (2006).

The Polish progress to a well-functioning market economy was crowned by invitation into the EU in 2002. It meant that the economy was considered to be good enough to stand competitive pressures on the European markets. The country became a member of the EU in 2004.

12.5 Privatization

If we compare privatization process in Poland with other Eastern European economies we can find both similarities and differences. First, the country suffered from the same lack of savings as the other countries of the Eastern Bloc (Zielinski 1993). This feature determined the privatization process because all domestic savings would cover only 15 percent of all the state companies' value in 1990 (Commander et al. 1995). But other aspects of the Polish situation were different. We should foremost bear in mind the position of employees and the trade unions in the companies. The employees' councils had in reality the veto right over the privatization process (Earle and Estrin 1996). Consequently, there was support for employee ownership of the companies as the way of privatization. In a survey from the beginning of the

1990s as many as 47 percent of the respondents preferred this form of ownership (Lewandowski 1997).

The first period of privatization is often referred to as “wild,” “rough,” or “spontaneous” (Gabrisch and Hölscher 1996; Lavigne 1999). It was made possible by laws approved at the end of the communist period. The decisions about selling or renting of the company were, at that time, in the hands of management, leaders of the trade unions, and chairmen of the employees’ councils. Companies were privatized into the hands of employees and respective managers. In other cases, the new owners recruited from cousins, relatives, or acquaintances of the firm’s former management. These were often linked with the previous regime (Bienkowski 1995). The assets were often sold for undervalued prices.

Later on the government created a legal environment for privatization. In Poland the first (temporary) privatization law in Eastern Europe was enacted in mid-1990. The disputes between proponents of employee ownership and advocates of classical privatization resulted in a compromise—employees were able to gain 20 percent of the company for 50 percent of the established price (Lewandowski 1997). A new privatization law was passed in 1991.

The Solidarity government during the first two years of the reforms approved two new forms of ownership change. The first was commercialization—when a company was transformed into a joint-stock company owned by the Ministry of Finance and prepared for consequent sale. There were approximately 100 companies of this type, each of a value higher than USD 15 million (Bienkowski 1995). The second way was liquidation, which was a procedure when creditors holding more than 50 percent of the debt of the nonsolvent company were appointed responsible for reorganization or winding-up of the company (Nestor and Thomas 1995). The old company was liquidated and parts or all of the assets were sold, rented, or transferred into a new company. This was the case with 5,500 small- and middle-size companies of a value up to USD 1 million (Bienkowski 1995). The new owners were mostly insiders—usually the management and employees and it often meant *de facto* legalization of the previous spontaneous privatization (Lavigne 1999). A significant role of privatization into the hands of employees or the management can be seen in Table 12.9.

Table 12.9: Employee ownership resulting from privatization in 1994 (rough estimates)

Country/base group of companies for estimation	Companies with employee control	Privatizations (percentage)	Average % held by all employees	Estimated total employment in companies with EO
Czech Republic (voucher privatization first wave)	3	1	4.4	n.a.
Hungary (self-privatization)	187	43	42.0	36,000
Poland (private liquidation)	1,478	75	50.8	450,000

Source: Earle and Estrin (1996).

Meanwhile, small privatization proceeded and 60,000 shops were sold or leased after dismissing of cooperatives at the beginning of the transformation (Commander, Coricelli, and Stähr 1995). Winiecki writes that it was a relatively quick process and by the end of 1991 three-quarters of shops and restaurants were privatized, although only 1–2 percent of them were sold, while the rest was leased (Winiecki 1993). By contrast, restitutions moved ahead only slowly and unwillingly. Moreover, there was a negative attitude toward foreign capital as well, which is not surprising if we realize that Poland had been under foreign control for nearly 150 years. Berend evaluates the first years of Polish privatization claiming that the process was generally affected by lack of capital and that it was extremely slow; at the end of the third year only 26 of the large companies and altogether only 556 companies out of 7,000 were sold. At the end of the fifth year just 13 percent of state companies were privatized (Berend 2009).

Polish politicians decided for a specific form of a voucher privatization in the middle of the first transformation decade as well.⁶ However, only 400 companies (later on 512) took part in this program. The whole concept was different from the Czech one. Large companies became parts of holdings that were governed by national privatization funds (NIF) with participation of foreign experts. There were twenty (later on fifteen) of these funds. The NIFs were supposed to conduct the restructuring of the companies. The inhabitants were allowed to purchase shares of these privatization funds. Each of the funds was mainly involved in approximately 30 companies (out of 512) and received 33 percent of the shares. Otherwise, the fund gained around 2 percent of shares in the rest of the companies. The process was a slow one. The setting of the funds was delayed because of political disputes until 1996. But this way of privatization was highly popular and 27.4 millions of adult Poles (95 percent of the eligible population) participated and purchased the certificates for 20

zloty (USD 8) (Lewandowski 1997). The inhabitants received tradable certificates that were exchangeable for shares of the NIFs. There was an obstacle in the functioning of the NIFs, because it was difficult to lure foreign experts into Eastern Europe and later on disagreements between foreign consultants and domestic managers appeared (Lavigne 1999).

The process of privatization proceeded, albeit at a relatively slow pace in comparison to Hungary. We can see the percentage of employees in private sector in Table 12.10. Privatization was unpopular in Poland, similar to other countries. A 2001 survey showed that 87 percent of the inhabitants wanted to keep large companies in the state's hands. In 2009 the government still wanted to privatize at minimum 800 companies including power stations and coal mines. The overall state ownership covered a minimum of 1,500 small companies (Junek 2009).

Table 12.10: Private sector share in employment (in %)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Poland	47.9	50.0	54.0	57.0	59.0	61.4	61.6	62.0	62.3	63.7	65.8	67.9	66.8	68.5	70.6
Hungary	n.a.	n.a.	81.4	78.1	77.6	77.7	78.7	79.2	79.5	80.0	80.4	79.6	79.3	79.1	79.1
Czech Republic	7.0	18.7	31.1	47.1	53.0	57.2	58.9	59.7	60.6	65.0	65.0	70.0	70.0	70.0	70.0

Source: EBRD (2007).

12.6 Development of the banking sector and the stock exchange

Changes in the banking sector began already in 1988 when the government created nine state banks and divided among them both good and bad credits of the National Bank of Poland. However, this change did not represent a real shift from the previous policy because managers in state banks kept providing state companies with additional credits without any reasonable consideration about repayments (Weill 2003). The transformation recession in 1990 and 1991 worsened the banks' position and the share of classified credits increased to 36.5 percent in 1993 (EBRD 2007). State banks preferred state companies even if they were not solvent (Zielinski 1993).

In 1993, the government launched a program of recovery of the banking sector—Enterprise and Bank Restructuring Program. The main method was recapitalization under the condition that the banks proceed with solving the

problem of classified credits by the end of 1994. The banks were supposed to deal with their problematic clients. The results of the program were deemed to be positive because the share of bad credits declined to 15 percent in 1996 (EBRD 2007). Meanwhile, the government started a program of bank privatization.

Banks gradually evolved after 1995 and started to provide consumption credits and hire purchase. Privatization of banks was planned to be finished by 1996 but at the end of 1997 only four heirs of the previous central bank were sold. Conversely, the share of foreign banks in the overall banks assets gradually increased to 50 percent by the end of the 1990s (EBRD 2007).

Poland suffered from a relatively high percentage of nonperforming loans for a long time. The percentage of bad loans again increased in the twenty-first century as we can see in Table 12.11. This development can be attributed to a relatively high role played by Polish state banks in the transformation period. Despite this, the overall costs of cleaning of the banking sector were calculated relatively low in comparison to other countries. Marton and McCarthy estimated them as 6 percent of GDP, compared to 10 percent in Hungary, 14 percent in Slovakia, and 15 percent in the Czech Republic (Marton and McCarthy 2008).

Table 12.11: Development of the banking system, 1989–2006

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Number of banks (foreign-owned)									
Poland	n.a.	n.a.	n.a.	n.a.	87 (10)	82 (11)	81 (18)	81 (25)	81 (28)
Hungary	26 (7)	32 (11)	35 (8)	35 (12)	40 (16)	43 (18)	43 (21)	42 (26)	45 (30)
Czech Republic	n.a.	n.a.	n.a.	n.a.	52 (18)	55 (21)	55 (23)	53 (23)	50 (24)
Asset share of foreign-owned banks (in %)									
Poland	n.a.	n.a.	n.a.	n.a.	2.8	3.4	4.4	14.4	16.0
Hungary	5.9	6.9	8.7	9.3	9.4	13.3	36.8	46.2	61.3
Czech Republic	n.a.	n.a.	n.a.	n.a.	7.3	11.2	15.5	19.0	23.3
Asset share of state-owned banks (in %)									
Poland	n.a.	n.a.	n.a.	n.a.	86.2	80.4	71.7	69.8	51.6
Hungary	85.5	81.2	75.3	74.4	77.2	62.5	50.0	15.3	3.5
Czech Republic	n.a.	n.a.	n.a.	n.a.	77.1	73.8	70.7	69.9	67.5
Nonperforming loans (in % of total loans)									
Poland	n.a.	n.a.	n.a.	n.a.	36.4	34.0	23.9	14.7	11.5
Hungary	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6.6
Czech Republic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	40.4	30.6	30.2

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Number of banks (foreign-owned)									
Poland	83 (31)	77 (39)	73 (46)	69 (46)	59 (45)	58 (46)	57 (44)	61 (50)	64 (53)
Hungary	44 (28)	43 (29)	42 (33)	41 (32)	38 (28)	38 (29)	38 (27)	38 (27)	40 (28)
Czech Republic	45 (25)	42 (27)	40 (26)	38 (26)	37 (26)	35 (26)	35 (26)	36 (27)	37 (28)
Asset share of foreign-owned banks (in %)									
Poland	17.4	49.3	72.6	72.2	70.7	71.5	71.3	74.3	74.3
Hungary	59.2	61.5	67.4	66.5	85.0	83.5	63.0	82.6	82.9
Czech Republic	26.4	38.4	65.4	89.1	85.8	86.3	84.9	84.4	84.7
Asset share of state-owned banks (in %)									
Poland	48.0	24.9	23.9	24.4	26.6	25.8	21.7	21.5	21.1
Hungary	9.8	7.8	7.7	9.1	10.7	7.4	6.6	7.0	7.4
Czech Republic	53.7	41.2	27.8	3.8	4.6	3.0	2.9	2.5	2.2
Nonperforming loans (in % of total loans)									
Poland	11.8	14.9	16.8	20.5	24.7	25.1	17.6	12.9	8.3
Hungary	7.9	4.4	3.1	3.0	4.9	3.8	3.7	3.1	3.0
Czech Republic	31.5	37.8	33.8	14.5	9.4	5.0	4.1	4.0	3.8

Source: EBRD (2007).

At the same time, we should note that Polish commercial banks played a relatively limited role in the economy. Table 12.12 shows that they, for example in 2002, provided only a limited amount of loans to the economy in comparison to the Czech Republic and especially to the other old EU countries.

Table 12.12: Financial sectors in European countries in 2002

Country	Banking assets (% of GDP)	Domestic credit (% of GDP)	Stock market capitalization (% of GDP)
Czech Republic	126	61	16
Hungary	61	42	19
Poland	66	39	14
Euro area	265	135	72

Source: Gabrisch and Hölischer (2006).

Stock exchange provides another source of capital for expanding business. The size of the stock exchanges in the postcommunist countries is small. However, the Polish stock exchange is deemed to be one of the most successful

in the whole Eastern Bloc. It was reestablished already in 1991; then the shares from the privatization process appeared on the floor, and the number of trading assets gradually increased. Environment that mobilized investors into perspective projects was created. Numbers of initial public offerings (IPO) in the Central European stock exchanges are shown in Table 12.13. The Polish stock exchange was in this measure by far the most successful among the transforming countries.

Table 12.13: Number of IPOs in Central Europe

	2000	2001	2002	2003	2004
Poland	11	6	2	2	31
Czech Republic	0	0	0	0	1
Hungary	0	0	0	1	1

Source: Kovanda (2005).

However, the picture changes if I take into consideration stock market capitalisation. This volume was not bigger than in other postcommunist countries and lagged behind the average in the Euro area in 2002 (see Table 12.12).

12.7 Economic results

Here I turn to the analysis of the development of the main economic indicators, including economic growth, indicators connected with GDP, and changes in the structure of the economy, as well as unemployment and inflation. The last subchapter is devoted to international connections of the Polish economy.

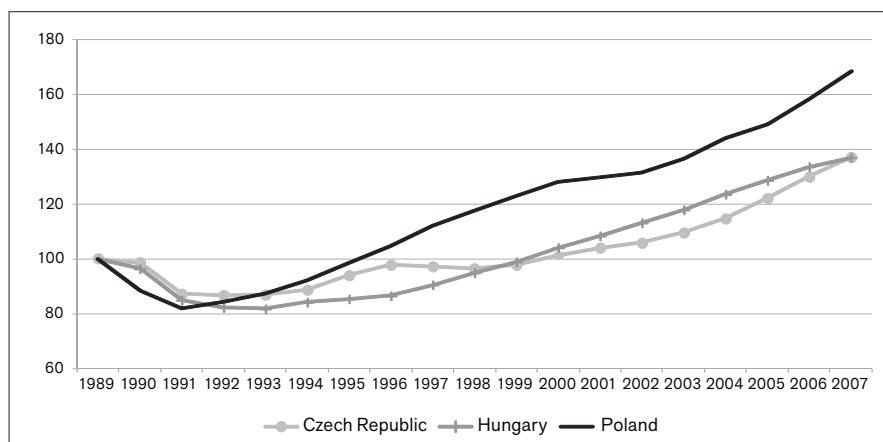
12.7.1 Economic growth

The Polish economy suffered from transformation decline at the beginning of the 1990s as well as other economies in the region. The difference was that the Polish economic decline started earlier due to the earlier start of the transformation process. The cumulative slump reached 17.8 percent of GDP after 1990 (EBRD 2007) and it was one of the smallest among the transforming countries (see Figure 12.6). The impact on the respective sectors was

possibly worse: industrial production declined by 40 percent and the production of the building sector by 25 percent (Orenstein 2001). Holman (2000) notes that unlike other countries, the Polish economy at the beginning of its transformation process was below its potential level. It means that the starting position was unequal and thus the results were incomparable. Jonas argues that Poland started its reform *de facto* in the 1980s (Jonas 2000). I can find the causes of the slump in the decline in domestic as well as foreign demand. In the former, it can be the decline in real wages that plummeted by nearly 30 percent in 1990 only (Winiecki 1993). Among the external causes affecting the Polish economy was foremost the plunge of exports to the former CMEA countries.

Economic growth resurged after 1992. Poland became the first country of the Eastern Bloc to reach the precrisis level of GDP in 1996 (see Figure 12.6). At the end of the first transformation decade only Poland and Slovenia achieved this level. However, we should bear in mind that Poland had an advantage in the low basic level and the fact that the state of the economy was below its potential at the end of the 1980s. Consequently, economic growth was easier and the economy was able to revive without additional investment.

Figure 12.6: Cumulative development of GDP (1989=100)

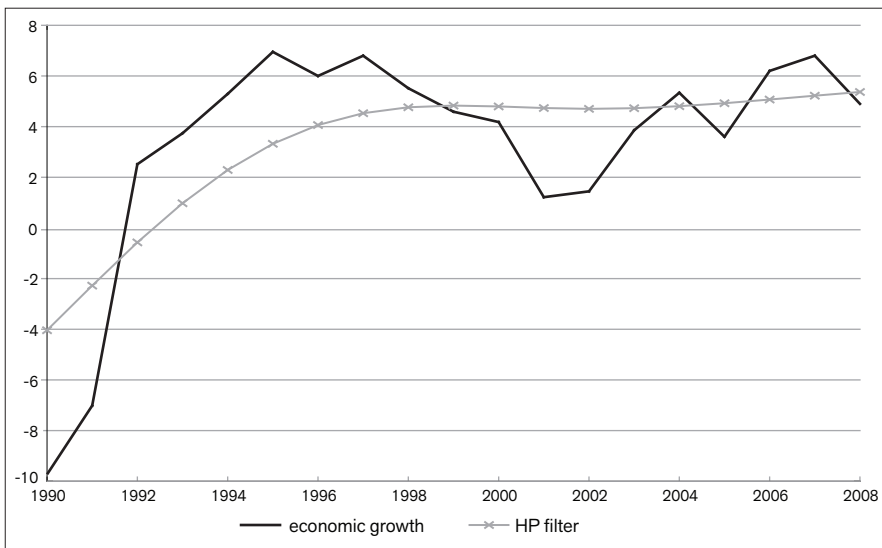


Source: EBRD (2007).

The economic conditions started to improve and strong economic growth was achieved in the mid-1990s. The basic development is depicted in Figure 12.7. However, the most important number in the figure is the trend. We should

compare it with the development during the communist reign. Obviously, the period following 1990 is marked by radical improvement. The country was hardly able to achieve positive growth in the 1980s and inevitably was lagging behind the developed countries. In the 1990s, after overcoming the transformation slump the economy got into the phase of continuous growth with just a temporary slowdown at the beginning of the twenty-first century.⁷ The trend of economic growth improved and contemporary the economy is able to catch up with developed countries.

Figure 12.7: Economic growth and long-term trend (by HP filter) in Poland, 1990–2008 (in %)



Source: Maddison (2010).

Economic development had a direct impact on real wages, which suffered from the transformation recession at the beginning of the 1990s and simultaneously declined. It led to the creation of the transformation buffer as in the Czech Republic. Consequently, high economic growth resulted in increase in real wages and according to some Poland and Hungary achieved the precrisis level in 1993 (compared to the estimated 89 percent in the Czech Republic; Jirova 2001). However, information about real wages notoriously varies and for example Jonáš writes that no country achieved the 1989 level prior to 1995 (Jonáš 1997). Another analysis is provided by Klaus and Tomšík (2007); their findings are presented in Table 12.14.⁸

Table 12.14: Real wages in Eastern Europe, the bottom, and situation in 2005 in comparison to the pretransformation year

Country	Year, when real wages reached the bottom	Cumulated growth of real wages against the bottom until 2005 (in %)	Cumulated change of real wages in 2005 against the pretransformation year (in %)
Czech Republic	1991	98	38
Hungary	1996	57	19
Poland	1993	43	2

Source: Klaus and Tomsik (2007).

General development of the country can be analyzed by broader measures as well. One of them is the Human Development Index (HDI) published by the UNDP.⁹ Table 12.15 shows the development of the indicator, where the index for Poland has significantly improved since the start of the transformation process.

Table 12.15: Development of HDI in Central Europe, 1975–2010

Country	1980	1990	2000	2005	2010	HDI rank
Czech Republic	...	...	0.801	0.838	0.841	28
Hungary	0.689	0.692	0.767	0.798	0.805	36
Poland	...	0.683	0.753	0.775	0.795	41
World average	0.561	0.602	0.638	0.658	0.678	

Source: UNDP (2010).

Our picture of the development in the Central European economies can be enlarged by an estimation of the size of shadow economies depicted in Table 5.7. We should remember that there are notorious problems with the estimation of the shadow economy, its definitions diverge and that all problems connected with measuring shadow economy are multiplied in the transformation process (see, for example, Hanousek and Palda 2006).

12.7.2 Structure of the economy

The whole economy changed significantly during the transformation. Table 12.16 demonstrates it by showing changes in the structure of employment. There was a general shift from agriculture and industry to services in the Polish economy. The changes were partly caused by the decline in production.

There was a severe slump in the production of several commodities; for example the production of steel declined from 20 million tons at the end of the 1980s to 8.4 million in 2004, production of coal slumped in the same period from 193 to 101 million tons (Berend 2009). At the same time, the sector of services grew.

Table 12.16: Employment by sectors (% of total employment)

	Czech Republic			Hungary			Poland		
	Agriculture	Industry	Services	Agriculture	Industry	Services	Agriculture	Industry	Services
1990	n.a.	n.a.	n.a.	18.2	36.8	45	25.2	37	35.8
1991	n.a.	n.a.	n.a.	16.1	36.1	47.8	25.4	36	38
1992	n.a.	n.a.	n.a.	11.3	35.1	53.4	25	34.6	39.8
1993	7.7	42.9	49.3	9.1	33.8	56.9	n.a.	n.a.	n.a.
1994	6.9	42.2	50.9	8.7	33	58.1	24	31.9	43.9
1995	6.6	41.8	51.5	8	32.6	59.3	22.6	32	45.3
1996	6.1	41.5	52.3	8.3	32.6	59	22.1	31.7	46.2
1997	5.8	41.1	53	7.9	33.1	58.9	20.5	31.9	47.6
1998	5.5	41	53.5	7.5	34.2	58.2	19.2	32.1	48.7
1999	5.2	40.1	54.6	7.1	34	58.9	18.1	31.3	50.6
2000	5.1	39.5	55.3	6.5	33.7	59.7	18.8	30.8	50.4
2001	4.8	40	55.1	6.2	34.2	59.5	19.1	30.5	50.4
2002	4.8	39.6	55.5	6.2	34.1	59.6	19.3	28.6	52
2003	4.5	39.4	56.1	5.5	33.3	61.2	18.4	28.6	53
2004	4.3	39.2	56.5	5.3	32.8	61.9	18	28.8	53.2
Change 2004/1990	-3.4	-3.7	7.2	-12.9	-4	16.9	-7.2	-8.2	17.4

Source: World Bank Databank (2010).

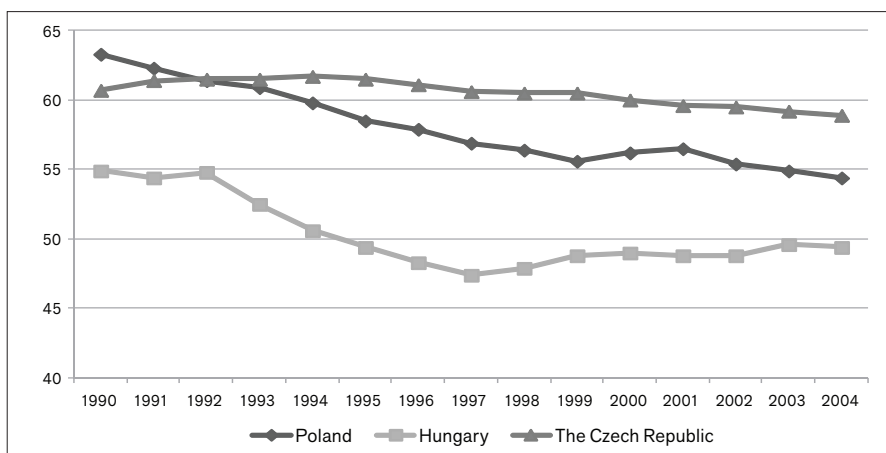
12.7.3 Unemployment

Poland suffered from a quick growth in the number of people without a job at the beginning of the transformation process. The unemployment rate jumped to relatively high values in 1990 and in 1993 more than 15 percent of the labor force were without a job. Situation on the labor market improved in the second half of the 1990s but again worsened at the beginning of the

twenty-first century when unemployment reached 20 percent (see Figure 11.11). Average unemployment reached nearly 15 percent of the labor force between 1990 and 2004 (EBRD 2007).

Analyzing the sole indicator of unemployment does not provide a full picture of the labor market. We should also take into consideration the development of employment, which declined in all Central European countries (see Figure 12.8). In Poland the decline was severe and labor force slumped by nearly 9 percent between 1990 and 2004. On the contrary, in the Czech Republic the decline was relatively small. Hungary had by far the smallest participation on the labor market among these countries.

Figure 12.8: Labor participation rate (% of population ages fifteen and over)



Source: World Databank (2010).

12.7.4 Inflation

Growing prices were deemed to be the most serious problem of the Polish economy at the beginning of the transformation process (Dabrowski 2003). The country suffered from high inflation toward the end of the communist regime, and the prices shot up even more after price liberalization in early 1990. The growth reached 100 percent in January even though the government applied tough restrictive policy. For comparison, prices increased by only 27 percent in January 1991 in Czechoslovakia (the first month following price

liberalization). The main culprit of the enormous growth in Poland was monetary excess in the economy (Holman 2000). The overall growth of price level in the first year of the transformation was more than 580 percent (EBRD 2007). Watanabe reminds us that there was a positive side of hyperinflation because it diminished company's debts and thus provided relief for them at the start of the transformation process (Watanabe 2002). In the years that followed, desinflation took place but its pace was relatively slow (Table 12.17), and inflation declined below 5 percent only in 2002.

Table 12.17: Development of consumers prices (annual average in %)

	Czech Republic	Hungary	Poland	Bulgaria	Romania	Slovakia
1989	1.4	17.0	251.1	6.4	1.1	2.3
1990	9.7	28.9	585.8	26.3	5.1	10.8
1991	52.0	35.0	70.3	333.5	170.2	61.2
1992	11.1	23.0	43.0	82.0	210.4	10.0
1993	20.8	22.5	35.3	73.0	256.1	23.2
1994	9.9	18.8	32.2	96.3	136.7	13.4
1995	9.6	28.2	27.8	62.0	32.3	9.9
1996	8.9	23.6	19.9	123.0	38.8	5.8
1997	8.4	18.3	14.9	1,082.0	154.8	6.1
1998	10.6	14.3	11.8	22.2	59.1	6.7
1999	2.1	10.0	7.3	0.7	45.8	10.6
2000	4.0	9.8	10.1	9.9	45.7	12.0
2001	4.7	9.2	5.5	7.4	34.5	7.3
2002	1.8	5.3	1.9	5.9	22.5	3.3
2003	0.2	4.7	0.8	2.3	15.3	8.5
2004	2.8	6.8	3.5	6.1	11.9	7.5

Source: EBRD (2007).

Consequently, price level increased in Poland significantly more than in the Czech Republic during the whole transformation period (see Table 12.18). Holman considers several reasons for this difference—more restrictive economic policy in the Czech Republic, lower wage requests, differences in tax policy, and especially the different exchange rate regime (Holman 2000). I suggest that inflation inertia or generally speaking historical circumstances had influence as well. Dabrowski reminds us of another factor and it is monetization of public debt (Dabrowski 2003). The Polish Central bank

financed an important part of the government deficit in the first years of transformation (see Table 11.8). Yet monetary policy in Hungary in this period was much more abused. In addition, Polish reformers had a natural advantage in liberalized prices; according to the EBRD in 1989 the share of administered prices in CPI achieved only 19 percent (EBRD 2007). Deregulation of prices was one of the main causes of inflation in the Czech economy during the transformation period. Janáčková adds that lower inflation in the Czech economy meant that the Czech companies were not cleared of the debts from the communist period and thus had to bear relatively higher costs of the transformation against inhabitants (Janáčková 2000).

Table 12.18: Cumulative growth of prices (1989=100)

	1989	1990	1991	1992	1994	1996	1998	2000	2002	2004
Czech Republic	100	110	167	185	246	294	352	374	399	411
Hungary	100	129	174	214	311	494	667	806	927	1036
Poland	100	686	1,168	1,670	2,987	4,577	5,880	6,947	7,467	7,792

Sources: EBRD (2007) and author's own calculations.

12.7.5 External relationships

At the end of the 1980s the main Polish trading partner was the Soviet Union. This situation changed in the early 1990s. International trade quickly reorientated toward the developed markets. To be precise, unified Germany became the main trading partner. The principal cause of this shift was a decline in trade with the former CMEA countries. For example, the share of the Soviet Union on Polish exports declined from 31 percent in 1989 to 11 percent in 1991; and the volume slumped from 4 percent of GDP to 1.5 percent (Zielinski 1993). During the same period exports to Romania declined by more than 80 percent, to Bulgaria by some 75 percent, to Hungary by 20 percent; and only exports to Czechoslovakia increased by 20 percent (all in nominal terms). Overall Polish exports into the former CMEA countries declined from 30.8 trillion zloty to 25.8 trillion, which means a decline of 16 percent in nominal and 42 percent in real terms (Zielinski 1993). Long-term development of Polish main trading partners is shown in Table 12.19.

Table 12.19: The main Polish trading partners and their share in Polish trade, 1929–2004 (in %)

		First partner	% of share	Second partner	% of share	Third partner	% of share
1929	Imports	Germany	27.3	United States	12.5	UK	8.5
	Exports	Germany	31.2	Czechoslovakia	10.5	Austria	10.5
1938	Imports	Germany	14.5	United States	12.2	UK	11.4
	Exports	UK	18.2	Germany	14.5	Sweden	6
1950	Imports	USSR	28.8	Czechoslovakia	13.2	DRG	11.5
	Exports	USSR	24.3	DRG	13.9	Czechoslovakia	9.2
1960	Imports	USSR	31.2	DRG	12.5	Czechoslovakia	8.5
	Exports	USSR	29.4	DRG	9.4	Czechoslovakia	8.5
1970	Imports	USSR	37.7	DRG	11.1	Czechoslovakia	8.6
	Exports	USSR	35.3	DRG	9.3	Czechoslovakia	7.5
1980	Imports	USSR	33.1	FRG	6.7	DRG	6.6
	Exports	USSR	31.2	FRG	8.1	Czechoslovakia	6.9
1985	Imports	USSR	34.4	FRG	9	DRG	6.1
	Exports	USSR	28.4	FRG	8.7	Czechoslovakia	6.2
1990	Imports	Germany	20.1	USSR	19.8	Italy	7.5
	Exports	Germany	25.1	USSR	15.3	UK	7.1
1995	Imports	Germany	26.6	Italy	8.5	Russia	6.7
	Exports	Germany	38.3	Netherlands	5.6	Russia	5.6
2000	Imports	Germany	23.9	Russia	9.4	Italy	8.3
	Exports	Germany	34.9	Italy	6.3	France	5.2
2004	Imports	Germany	24.4	Italy	7.9	Russia	7.2
	Exports	Germany	30.1	Italy	6.1	France	6

DRG—Democratic Republic of Germany; FRG—Federal Republic of Germany

Source: Central Statistical Office (2007).

This decline in trade in Central Europe led to an attempt to reverse it and to forming of the Central European Free Trade Area (CEFTA) in the early 1990s. The CEFTA was initially formed by Poland, Hungary, Slovakia, and the Czech Republic. Polish trade with the EU was liberalized during the 1990s as well. But the average Polish tariffs stayed relatively high during the transformation period (see Table 12.20).

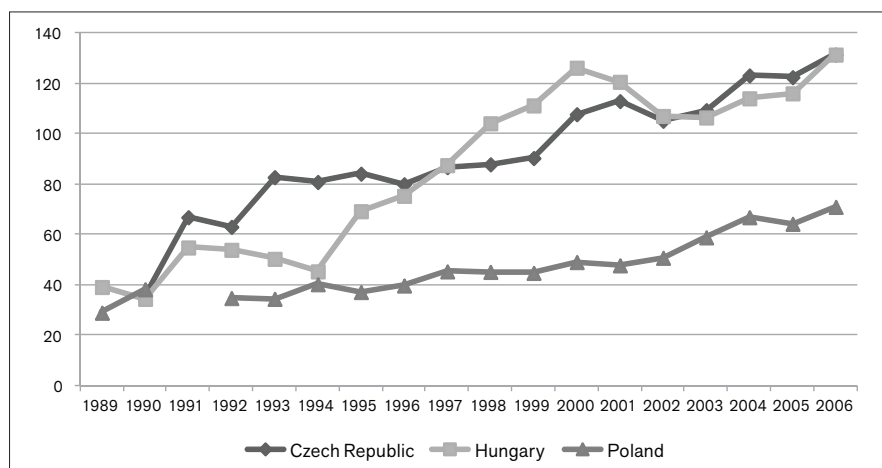
Table 12.20: Development of the average tariffs (in %)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Czech Republic	5.3	—	—	4.8	4.8	5.0	7.7	7.3	6.9	6.8	6.5	6.1	6.0	6.0
Hungary	—	12.7	12.6	8.5	8.5	—	15.2	14.3	13.3	12.4	11.9	11.7	9.5	9.5
Poland	—	12.2	11.7	8.5	8.5	11.6	18.7	13.1	—	15.9	14.5	12.6	13.9	13.9

Source: Jandova (2007).

Regardless of the relatively high tariffs, the country integrated into the world economy. The share of exports and imports in GDP increased from 29 percent in 1989 to 67 percent in 2004 (EBRD 2007; see also Figure 12.9).

Figure 12.9: Trade openness in Poland, Hungary, and the Czech Republic
(exports plus imports to GDP, in %)



Source: EBRD (2007).

Poland did not avoid trade imbalance and suffered from a relatively high deficit of the current account at the end of the first transformation decade (see Figure 11.13). Nearly all the transformation economies were struck by similar problems in some phase of the transformation during the 1990s. Of all the Eastern Bloc countries, only Slovenia was able to avoid a higher deficit of the current account.

Regarding capital transfers, I concentrate on the foreign direct investment (FDI). The mood in Poland at the beginning of the transformation period

was similar to other countries and there was no political support for selling of the domestic companies to foreigners (Berend 2009). Nevertheless, the country was among the biggest receivers of FDI in absolute terms as we can see from Table 12.21. Lavigne (1999) for example writes that Hungary, Poland, and the Czech Republic gained as much as 84 percent of all FDI in Eastern Europe by 1997. The view of Poland is different if we consider FDI per person (see Table 12.21) because according to this measure the country lagged behind the leaders. As a consequence of foreign investment, companies from abroad are currently playing a growing role in the Central European economies. As can be seen from Table 11.20, the role of foreign companies in the industries was already decisive at the end of the 1990s.

Table 12.21: Cumulative FDI inflows in absolute terms and per capita in Eastern Europe, 1989–2004

Country	Cumulative FDI inflows, 1989–2004 (in millions of USD)	Cumulative FDI inflows per capita 1989–2004 (in USD)
Czech Republic	41,704	4,045
Hungary	37,189	3,719
Poland	56,333	1,471
Total Central European and Baltic countries	161,255	2,313

Source: Berend (2009).

The last factor of production is the labor force. Emigration from Poland declined after 1990. At the same time, immigration into the country increased. Consequently, net migration declined after 1990. There was another shift in the labor market in the form of a sharp growth in emigration after the Polish admission into the EU. The overall development of migration can be seen in Figure 12.1.

We have become familiar with the development of the Polish economy and society during the transformation period on the pages above. We could realize that economic conditions dramatically changed. During the period of the communist reign the economy was decaying. And the economic situation at the end of the 1980s was critical. The economy suffered from slow economic growth, hyperinflation, and lack of basic consumption goods. Shock therapy was applied in order to radically change economic conditions in the country. This cure improved the economic situation in medium term but in short term (at the beginning of the 1990s) it brought about transfor-

mation recession and hyperinflation. Polish economic conditions enormously improved following the overcoming of this recession. Political situation changed quickly during the transformation period and the governments were relatively unstable. Polish economists had to face many tasks, including privatization and improvement in banking sector. The privatization process was slow and postponed. Economic growth was relatively high and the economy was able to catch up with developed countries. The main goal of the economic transformation, in the form of improving the ability of the economy to grow, was achieved. The economy established a growing trend and was able to catch up with developed countries during the transformation and posttransformation period. The transformation process was crowned by Poland's admission to the EU.

Notes

- ¹ This chapter is based on Židek (2011).
- ² I can mention several events—occupation of a part of Poland between the end of the eighteenth century until the start of World War I; the Polish-Russian War (1919–21); the Molotov–Ribbentrop pact that divided Poland between Germany and the Soviet Union at the beginning of World War II; or the massacre of thousands of Polish officers by Russians troops in the Katyn Forest in 1940.
- ³ He was the minister of finance until the end of 1991 and then again in 1997–2000. He held the position of the president of the National Bank of Poland between 2001 and 2007.
- ⁴ Kolodko (1991) mentions that these index coefficients were small.
- ⁵ This was because the reformers were preoccupied with stabilizing the economy (Duvivier 1997).
- ⁶ The idea of a voucher privatization originated in mid-1988 and was raised by the market-oriented economists connected with Solidarity (Lewandowski 1997). The voucher privatization proposal was introduced in 1991 but its real application started only in 1995.
- ⁷ The Polish economy recorded growth even during the last global recession in 2008.
- ⁸ The differences among the authors could be caused by discrepancies in defining the “pretransformation” or “precrisis” level.
- ⁹ The Human Development Index sums up GDP per person, literacy and life expectancy.

FINAL ASSESSMENT

This book has focused its discussion on the development of the Czech economy and compared it with the development in Poland and Hungary during the transformation era. During the discussed transformation period, the Czech—as well as the Hungarian and Polish—economy underwent an exceptional qualitative shift from centrally planned to a market system. The transition was highly demanding from the very first step. The governments had to make many problematic decisions. Obviously, not all decisions appear to be ideal from today's standpoint. The entire society faced towering obstacles and in the process learned—and continues to learn—how to behave under new conditions.

How should we assess the transformation as a whole? I have already passed numerous judgments about specific issues. But what would a complex assessment look like? I now sum up the entire process, including the negative and positive aspects of what has already been said in this book. I want to add that this judgment is offered from an economics point of view, although I am aware that it was primarily the political environment that determined the entire process.

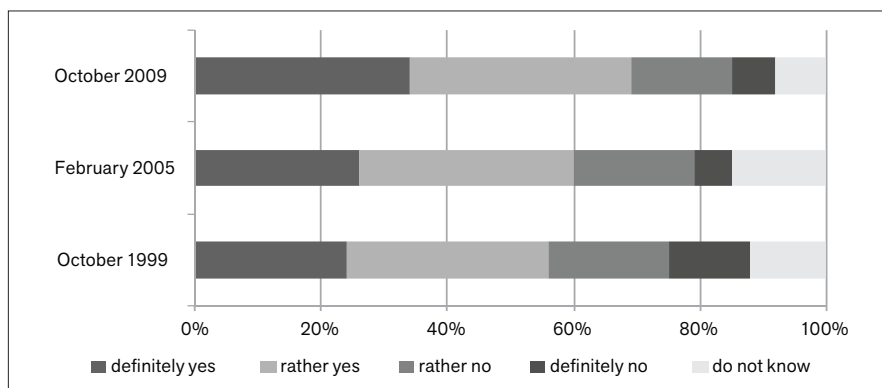
13.1 Broad issues

I want to discuss three topics that I consider critical for broad evaluation of the transformation process—political/democratic stability, development of GDP, and general direction of the transformation process.

First, I want to stress the most important point—it is not the economy but the general political development. I must admit that there was a lot of criticism

about the state of the Czech democracy but during the entire transformation, the democratic drift of the country, and the newly acquired freedom were not seriously threatened. The political environment in general was stable and by definition democratic. I consider it to be the greatest achievement that many people seem to take for granted. I also admit that even if it were just for this fact alone, I would assess the entire period positively. Material advancement would mean nothing without the freedom to travel and speak freely. I agree with Kornai that our democracy and freedom are definitely worth slower economic growth (see Kornai 2006). Most importantly, there is a general support for the new regime. Figure 13.1 shows that the view of the Czech public is moving in the direction against the previous regime. The return of the communist reign was supported by only 13 percent of the population twenty years after the regime's fall (CVVM 2009).

Figure 13.1: Was the change in 1989 worth undergoing? (survey from June 2007)



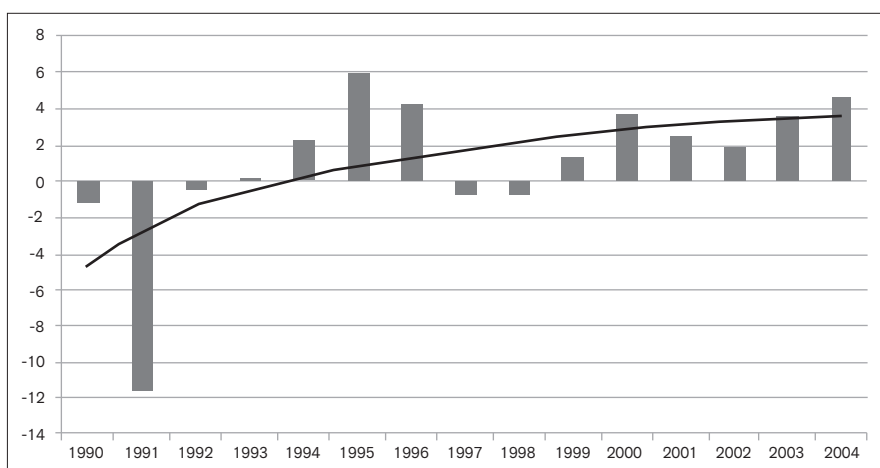
Source: CVVM (2009).

The political development in both of the other countries—Poland and Hungary—was similar in terms that the regimes were democratic. All of the considered countries experienced premature elections and their political stability was not very high but it is not surprising if we take into consideration the previous political history during the socialist times. The main conclusion is that the states and the values stayed democratic. The only thing I find odd is that so many Hungarians think back of socialism as a positive period.

Let us think about the second point and the main economic issue. I think that the fundamental success of the entire process is quite obvious, simply

take a walk in any Czech town or village and look around. Everyone can see the difference compared to 1989. Just notice what the freeing up of the market forces meant, how much creativity is associated with private initiative, how many small and big shops, companies and factories emerged in the country and how they prosper. We should try to find more tangible measures of the transformation progress. If I choose a single measure to evaluate economic state of the development I would definitely consider the trend in growth of GDP or say potential growth. It is a crucial measure because it is only partially affected by the current cyclical development that says nothing about the long-term trend. I would like to remind the reader that the trend during the centrally planned period was down sloping in all three countries and that economic growth in the 1980s was at best negligible. Communists hoped for an economic miracle that would save the system but there was no perspective of improvement.

Figure 13.2: Economic growth and growth trend in the Czech Republic, 1990–2004



Source: EBRD (2007).

How did this measure develop? Is the economy functioning better? We can find answers to these questions in Figure 13.2. The growth trend of the Czech economy was initially negative with the transformation recession but then substantially increased. There can be of course different measures of the growth trend but it does not change the core of the argument—potential growth in the contemporary Czech economy is markedly higher than it used

to be during the communist reign. The economy was denounced to lag behind the developed world in the period of the centrally planned system. After the transformation process, it is able to catch up with developed countries. From my point of view this proves that the main economic task of the transformation has been achieved, even if the growth could be higher. Improvement in this measure is crucial for all the others, like for example growth of real wages.

If I compare this development to Hungary and Poland, I can observe the same patterns. In both countries the trend of economic growth totally changed and from unavoidable lagging behind during the communist reign the countries were able to catch up. Especially Poland grew (even if from a low base) significantly and achieved one of the best results among the transforming countries.

All of the considered countries were affected by cyclical development and had strong and weak moments in the transformation period. But in general, we can see the development positively even though the respective developments were criticized, especially in Hungary and the Czech Republic. All three countries were able to adapt to tough economic environment of the world economy and the European Union until 2004. All of them opened and integrated into the world economy—it means that the quality of the production had to increase enormously. Each country faced high costs of the transformation process—foremost connected with the transformation recession at the beginning of the 1990s. But again we should try to see the development in these three countries in a broader context. Table 13.1 shows that the course of the transformation recession was rather mild in Central European countries compared the other new members of the EU, not to mention other postcommunist countries. The slump in some of them was enormous and by 2004 some reached only 45 percent of their level from 1989.¹ At that time, the level in the Czech Republic, Hungary, and Poland was much higher even if they started from a higher economic level and thus we could expect lower economic growth. I can conclude that from this point of view no tragedy happened in the Czech Republic (as well as in the two other countries) neither at the beginning of the 1990s nor in 1997.

Table 13.1: Cumulative economic growth in transforming countries, 1990–2004

	1989	1990	1991	1992	1993	1994	1995	2000	2004
Czech Republic	100	98.8	87.3	86.9	87.0	88.9	94.1	101.5	114.8
Hungary	100	96.5	85.0	82.4	81.9	84.3	85.5	104.2	123.7
Poland	100	88.4	82.2	84.3	87.6	92.1	98.6	128.3	144.0
Bulgaria	100	90.9	80.3	74.4	73.3	74.6	76.8	73.6	89.7
Estonia	100	93.5	80.8	69.3	63.2	62.2	65.0	87.5	117.8
Latvia	100	102.9	92.2	60.0	51.1	52.2	51.8	68.3	91.6
Lithuania	100	95.0	89.6	70.6	59.1	53.3	55.1	69.1	93.8
Romania	100	94.3	82.1	74.9	76.1	79.1	84.7	79.4	100.6
Slovakia	100	99.6	83.8	78.2	75.3	79.9	84.6	101.2	119.5
Slovenia	100	92.5	84.3	79.7	81.9	86.3	89.8	111.4	127.8
Albania	100	90.0	64.8	60.1	65.9	71.4	80.9	102.9	129.1
Armenia	100	92.6	81.8	47.6	43.4	45.7	48.9	62.8	97.7
Azerbaijan	100	88.3	87.7	67.9	52.2	41.9	37.0	53.6	79.8
Belarus	100	97.0	95.8	86.6	80.1	70.7	63.3	85.9	112.6
Croatia	100	92.9	73.3	64.7	59.5	63.1	67.3	79.6	96.4
FYR Macedonia	100	90.1	84.5	78.9	73.0	71.7	70.9	82.0	84.6
Georgia	100	87.6	69.6	38.4	28.6	25.4	26.0	34.3	44.6
Kazakhstan	100	99.6	88.6	83.9	76.2	66.6	61.2	69.1	103.2
Kyrgyz Republic	100	105.7	97.4	83.9	70.9	56.7	53.6	70.4	84.9
Moldova	100	97.6	80.5	57.1	56.4	39.0	38.4	33.9	44.3
Russia	100	97.0	92.2	78.5	71.7	62.6	60.1	65.1	82.3
Serbia	100	92.1	81.4	58.7	40.6	41.6	44.2	46.1	56.7
Ukraine	100	96.0	85.8	77.5	66.5	51.3	45.0	40.7	57.5
Uzbekistan	100	101.6	101.1	89.9	87.8	84.1	83.4	98.0	119.1

Source: EBRD (2008).

I find all the efforts to determine which of the transforming countries should be considered a leader ridiculous. It is one of the most pointless approaches to the entire transformation process, because, according to foreign analysts, practically all Central European countries occupied the leading position at one time or another—first it was Czechoslovakia and the CR. When the recession set in, the analysts seemed to have forgotten about the fact that Hungary in the mid-1990s was on the verge of a similar catastrophe that hit Mexico, and yet Hungary took the lead (a welcomed reason for self-damnation in the CR). In the early 2000s, Poland was frequently referred to as the leader and it appears to me that later on Slovakia became the clear reform leader

after 2002. Of course, my opinion is that considerations about leadership in transformation are totally illusory because it is based on a short-run cyclical development whereas only the long-term development is really important.

The last issue that I want to discuss in the first part of the evaluation is the overall direction of the transformation process. From the opinions I offered in this book, it should be obvious that as far as an economic assessment of the transformation goes, I tend to agree with the reformers rather than their critics, namely because I agree with the reformers in the perception of the state, politicians, and bureaucracy. I believe that the politicians and bureaucrats follow primarily their own goals—to stay in power, to maximize the resources in their competence. I am also very skeptical about the skills of the state bureaucracy. I have not yet seen any proof that the state officials are able to for example restructure companies—that is to fire employees. It was especially true at the beginning of transformation, but it still remains true today.

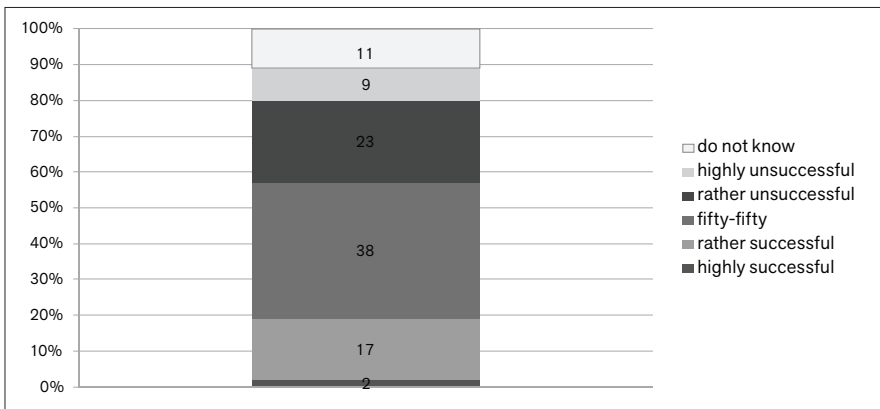
Criticism “from the left” stems from the different notion of the state. Such critics as Sojka, Mlčoch, Mládek, or Pick have much higher confidence in the state and bureaucracy and believe that they are able to implement restructuring. Another characteristic feature is that these critics often thought that the initial situation was much better than the reformers and me. It is up to the reader to use his own experience to form an opinion about these issues.

I find most of the criticism to be destructive. It is easy to point out what is wrong rather than offer an alternative option, and the hardest thing is to admit negative aspects of one’s own proposal. The critics seem to always overlook the negative aspects of their own proposals. It is easy to criticize the poor state of institutions or the moral condition of the society. What is the government supposed to do with it? How to improve the moral state of the society within a few years? How to change informal institutions that developed in decades of totalitarian systems? Is there anything surprising about tunneling and corruption? I understand that these are serious social issues, but such is the current situation. Contemporary society has to face this situation and new laws have only limited impact on informal institutions. It is necessary to change the informal institutions, which takes a long time, certainly not the several years of transformation effort. There is not much a government can do about it. It seems as if the critics forgot about the determination concerning the initial situation, as all institutionalists point to path dependency, but appear to ignore it. I find such criticism to be misguided. Moreover, this type of criticism flourished during the economic crisis, when

it was fashionable to interpret the recession as “the end of the world” and the total failure of institutions. Such voices are not heard any more. The critics have apparently used the situation to attack the reformers. Conversely, it is obvious that the criticism was omnipresent also due to exaggerated optimism of the previous governments and especially Prime Minister Klaus.² In this regard, economists should have understanding for Klaus, because the economy is determined by expectations, and who but the prime minister should spread positive expectations. I am not saying that problems should be ignored. But let us face the fact that all transforming countries “had their weak moments”—slower economic growth in some countries, or a GDP drop in others. All in all, I consider the direction of the transformation process as positive.

But how does the public evaluate the process? We can see the results of one of the surveys from 2007 in Figure 13.3.³ The question asked was if the transformation process was successful. Most of the respondents said that it was fifty-fifty. Thirty-two percent saw it as partially or completely negative way and only 19 percent as partially or entirely successful. In addition, 20 percent of the respondents said that the reason for failure of the transformation process was economic criminality, 7 percent complained about privatization and IPFs, and 5 percent about wrong or inconsistent legislative. The positive side mentioned mostly aspects like economic development (8 percent), chance to start own business (7 percent), good supply of goods—lack of queues (6 percent) and even privatization process (4 percent) (CVVM 2007).

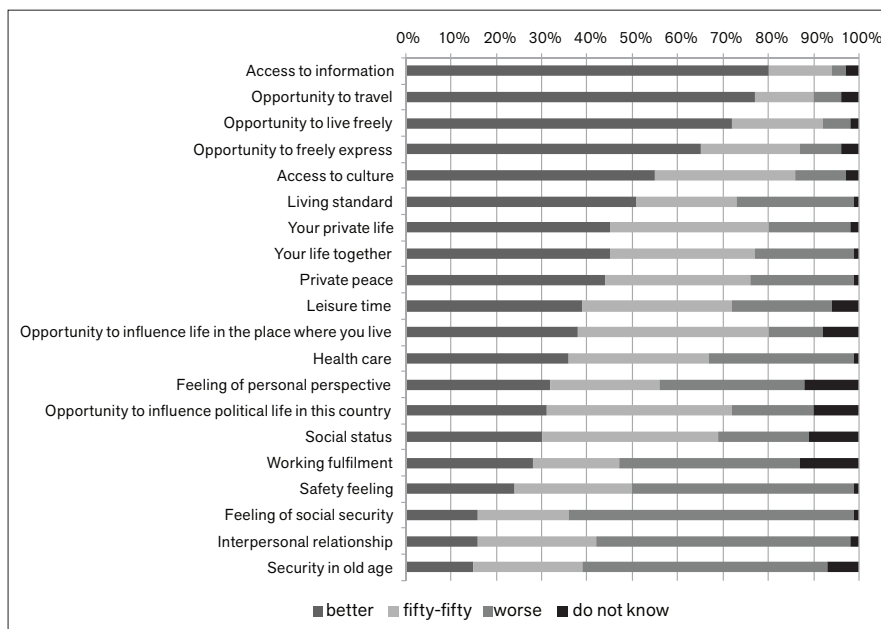
Figure 13.3: How do you evaluate the transformation process? (survey from June 2007)



Source: CVVM (2007).

There are other surveys that present interesting views of the population on the comparison of the transformation results with the situation before 1989. One of them was organized twenty years after the political change. Figure 13.4 shows that transformation successes are connected with liberties, while cons are determined by social issues.

Figure 13.4: Comparison of contemporary life with life before 1989 in different areas

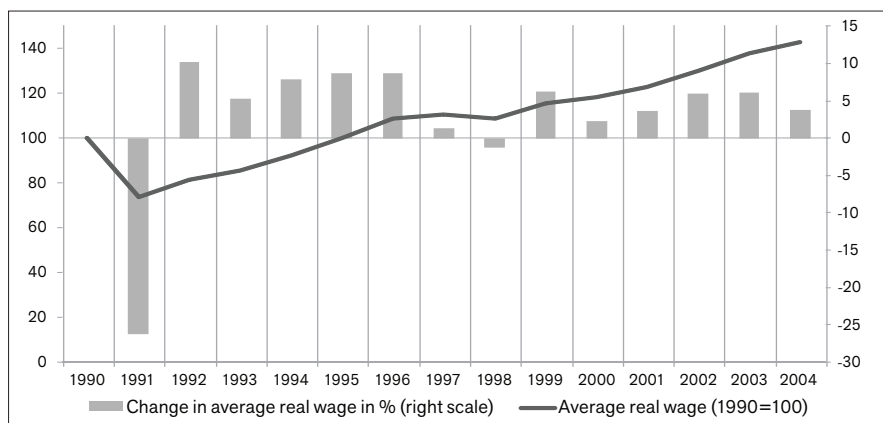


Source: CVVM (2009).

13.2 Specific issues

Let us now discuss some of the more particular successes and failures of the transformation in the Central European countries. The crucial indicator is the development of real wages shown in figure 13.5. We should notice that real wages in the Czech Republic in 2004 achieved on average 140 percent of the 1990 figure. This is a significant increase that more than balanced the slump at the beginning of the 1990s.

Figure 13.5: Development of real wage: Index (1990=100) and year-to-year change (in %)



Source: ČSÚ (2009).

We will obtain similar results even if we analyze overall macroeconomic statistics. Per capita GDP increased from 12,500 dollars in 1990 to 19,500 in 2004 according to PPP, and nearly tripled according to the exchange rate. Compared to the eurozone, the Czech GDP improved from 61 percent in 1991 to 68 percent in 2004. Similar achievements apply to Hungary and Poland as well. The Czech Republic also scores relatively well in international comparison—a Czech with an average income belongs to 13 percent of the richest people in the world (ČTK 2005). For example, the World Bank ranked the country as developed in February 2006. However, the key long-term indicator is the tempo of potential product discussed earlier in the chapter.

The growth in real wages and GDP per person was expressed in growing consumption as well. The Czech consumers were much better off at the end of the transformation process than at the beginning. Long forgotten are the grocery stores with shelves full of rusty juice cans and dusty syrup bottles or long lines. The achievements of the market economy are taken as granted, which is how it should be, but it might be useful to occasionally recall what it was like under the former regime.

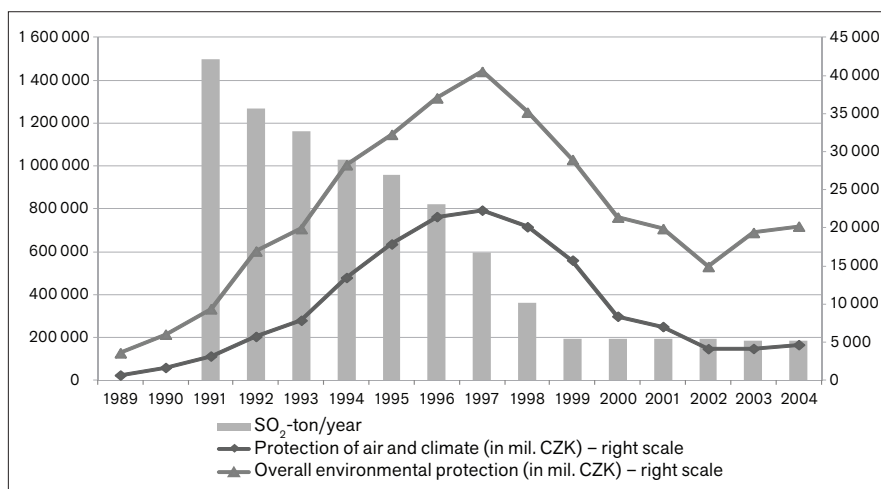
We can present several numbers as examples of the material development of the Czech consumers. Let us note that in 2004, there were 125 TV sets, 160 refrigerators, 104 automatic washing machines, over 70 cars, 196 telephones (landlines and mobile), and 36 PCs per 100 households (ČSU 2006). In 1989,

8.6 million people traveled abroad, mostly eastward. That number rose to 40 million in 1999, and 37 million in 2004.

Growth of real wages and overall growth depends on growth in productivity. This indicator steadily increased in most of the transformation period. The reasons for increasing productivity were among others in privatization, foreign investment in the economy, and foreign competition. Increasing productivity went hand in hand with growing competitiveness that can be among others expressed by the level of openness of the economy, measured as for example exports to GDP. The CR, as well as Hungary, has become one of the most open countries in the world and the majority of its exports go to demanding western markets. Before 1989, Czechoslovak manufactures could only dream about something like this. I should add that growth of openness took place in the Czech Republic under a stable exchange rate and quite a stable price level. Generally, macroeconomic indicators were sound for most of the period.

Noneconomic statistics improved as well. Average longevity increased, infant mortality decreased, and the environment improved dramatically after a massive spending—350 billion of crowns between 1990 and 2004 (see Figure 13.6).

Figure 13.6: Investment in environmental protection (in millions of CSK/CZK) and SO₂ pollution (in tons per year)



Source: ČSÚ (2010).

What were the drawbacks? I can be of course critical of some macroeconomic conclusions of the transformation process. It is undeniable that GDP itself increased by only 15 percent by 2004, and some of the postcommunist countries, for example Poland, grew (much) more. There are other questionable values—for example agricultural production was in 2004 still significantly lower than in 1990. But I see the general slump in production at the beginning in a *de facto* positive way because it meant that we stopped producing goods that nobody wanted to purchase. I should add to the negative side that there were periods of macroeconomic imbalance, especially deficits of the trade balance and current account in the mid-1990s and the subsequent currency crises.

It is certainly true that transformation achievements were more generous to some groups, for example there was a drop of pensions in the ratio to real wage. Namely the formerly preferred groups were relatively worse off.⁴ The result was higher inequality in the division of revenue in the society, which is not surprising with regard to the initial egalitarian setting (Myant 2003). But Fawn notes that during transformation the CR had the smallest number of conflicts between the rich and the poor of all Central European countries, that the poverty level is the lowest in the whole postcommunist area (Fawn 2000). Most important, in 2004 the Gini coefficient was still around 25 in the Czech Republic and Hungary, which is among the lowest in the world. The reasons and consequences of these mentioned “macro” points are dubious. For this reason, I want to concentrate on something that we can label as specific mistakes in economic policy.

I want to stress that the transformation was an extremely difficult process full of unavoidable compromises and traps. I stress that the reformers were generally successful but it is still important to discuss some steps that should have been taken in a better direction. What can one criticize the reformers for? I believe the reformers handled the beginning of the transformation well and the measures they took helped the economy greatly. The subsequent slowing down of the reform is an issue in dispute. I am aware of the political implications, the fact that the general political will to continue the reforms was declining. There certainly was a certain fatigue from the previous hectic development. Nevertheless, the government should have found the courage to continue with unpopular reforms—reforms are always easier to implement during an economic boom. I believe that one of the most serious mistakes was the total postponing of the banks’ privatization. There is no doubt the

expenses would arise in any case. However, if the banks were sold and loans potentially limited during the strong economic boom in mid-1990s, the expenses for taxpayers would not have been so high. Similarly, the reformers should have found courage to finish price liberalization during the economic boom. The Czech way of privatization, in the form of direct sales to domestic bidders also appears to be problematic to me. It is clear that potential foreign buyers wanted just pieces of large companies, but a radical cut was perhaps necessary. By far the worst mistake happened with privatization funds. Some of them abused their position and it had decisive impact on the view of the whole privatization process.

I see another big problem in bankruptcy legislation. It is obvious again that the government had to find a compromise, but I believe the decision was too soft and the number of bankruptcies should have been higher, which would purge the economy. The social democratic governments carried out fairly sound economic policy primarily due to fiscal restrictions that could not be entirely ignored because of the pressure from the European Union. Nevertheless, the budget deficits in that phase of the economic cycle were alarming.

I am also critical of certain aspects of the central bank policy. I understand that its policy was formulated in complete uncertainty and it was a success that inflation was limited to an acceptable level. However, on several occasions, the bank exaggerated restrictions and was too ambitious. It, for example, permanently undershot its own inflation target. Even that would be understandable but the bigger problem was the unwillingness to accept responsibility for this policy at that time.

The last points that I want to make are institutions, legal system, and the setting of the entire economy. Czech institutions are still far from perfect. There were obvious mistakes in legislatures that appeared for example in allowing tunneling. Some mistakes were unavoidable but several times it took a really long time before these problems were fixed by the parliament. Conversely, the legal system and other institutions were good enough for the country to be admitted to the EU. The current state of informal institutions is still strongly determined by the initial state and it will take a long time before it will be on a par with countries whose development was not interrupted by fifty years of totalitarian regime.

Evaluating the whole process, I must stress that it was difficult and complicated. Especially at the beginning of the 1990s no one knew how the

economy would react and what would happen. From our contemporary point of view it was almost easy or trivial but the decisions at that time were really demanding. I believe that we should admire the first steps taken in Czechoslovakia, Hungary, and Poland. The governments in some other countries, for example Bulgaria and Romania (not to mention Ukraine), were brave to a much lesser extent and it had highly negative consequences for the following transformation process. The decisions made at the beginning put the economies in good directions that led to well-functioning market economies. The transformation process changed the overall direction of the economy from steady lagging behind the developed countries to a catch up process. On the way to the market economy, there were of course mistakes and without doubts, in retrospect, some steps might have been taken in a different way. But the overall transformation process in Central Europe is a success story.

Notes

- ¹ It is certainly worth mentioning that the countries that tried to proceed “gradually” faced much worse problems. It seems as if there was indirect proportion between pace and expenses.
- ² Fawn writes about Klaus’s high expectations and brazen self-confidence before 1997 (Fawn 2000).
- ³ Two thousand seven was a good year before the start of the global financial crisis thus it is not affected by the consecutive development.
- ⁴ Myant for example mentions the relative drop in wages in the coal mining sector, where the index of average wages amounted to 151 in 1989 and to only 121 in 1996 (Myant 2003). Similarly in agriculture, wages dropped from 4 percent above the average to 25 percent under the average.

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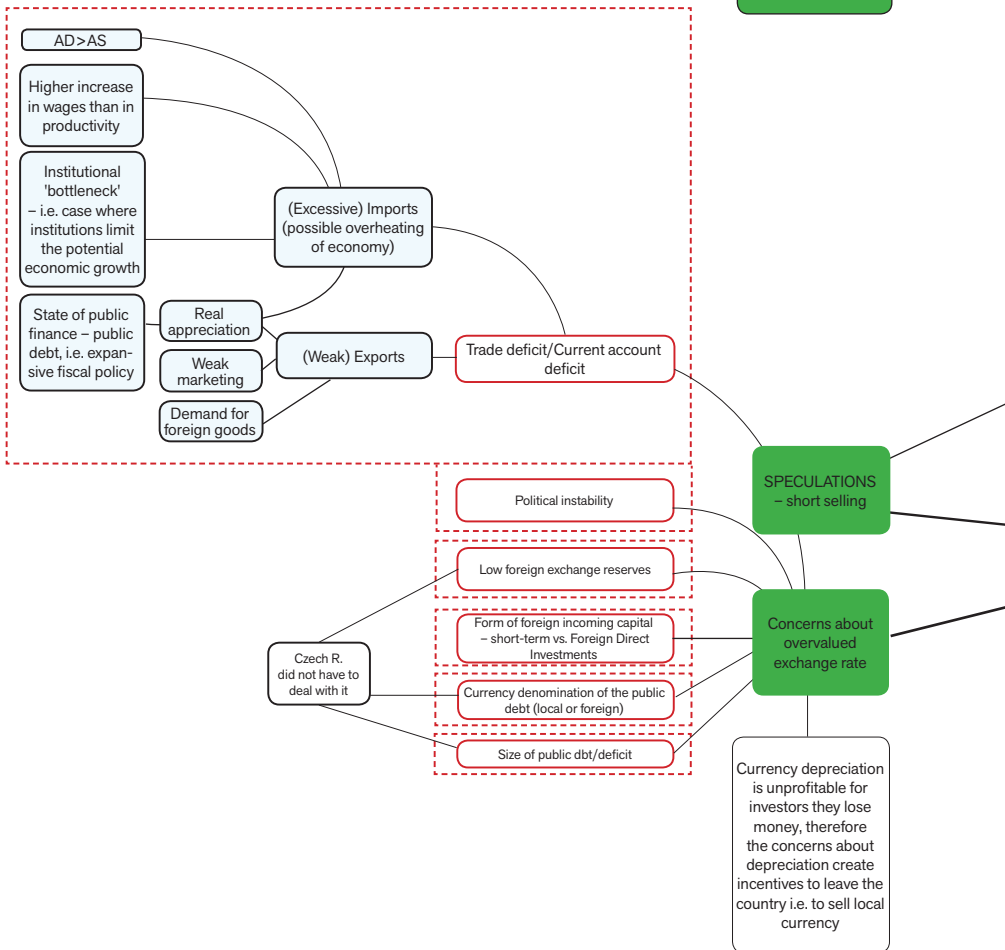
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LEGEND ⇨

Red framed – statistics
observed
by investors

Green
– direct causes of
currency crisis



Orange – necessary conditions for creating a crisis

Blue – Crisis solutions – i.e. central bank activities

Yellow – direct steps executed by central bank in crisis

Red – consequences of currency crisis

Speculators borrow local currency and sell it in foreign exchange market. They wait until the currency depreciates in value and repurchase it back for lower price. They return the loan + interest rate. The difference is profit.

Nobody knows what's the scale of speculations in causing currency crisis. We can only speculate :-)

CURRENCY CRISIS
(massive selling of local currency in foreign exchange market which further leads to abandonment of fixed exchange rate)

Banks have large amount of classified loans

Various definitions. Generally, even if interest rates are lowered by CB (after the currency crisis) commercial banks are not willing to provide loans.

Financial/bank crisis

credit crunch = credit freeze

Economic crisis

Other factors triggering the crisis – e.g. foreign demand

Necessary conditions

Full convertibility – i.e. free capital flow

Fixed exchange rate

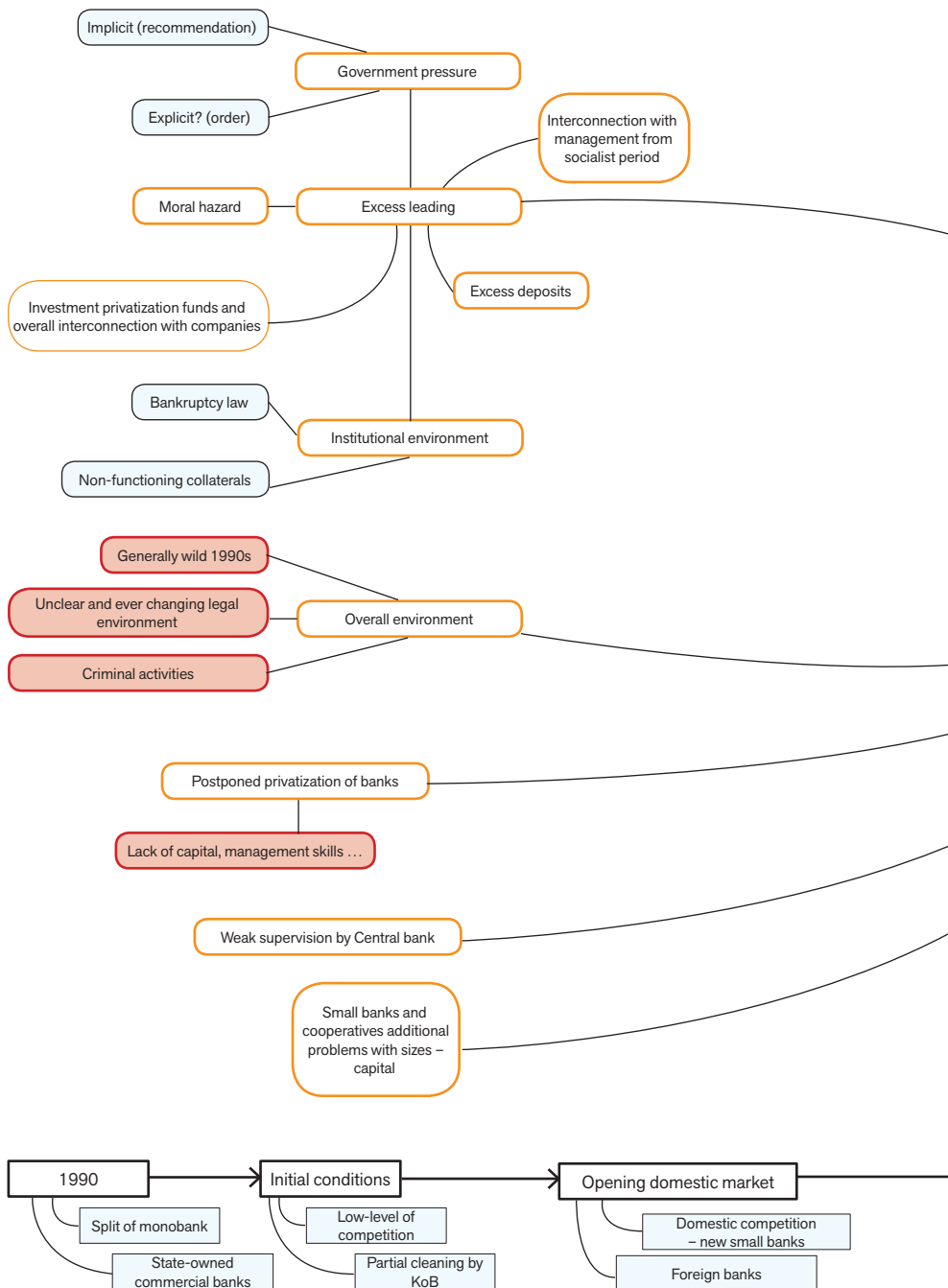
Crisis solutions – CB activities

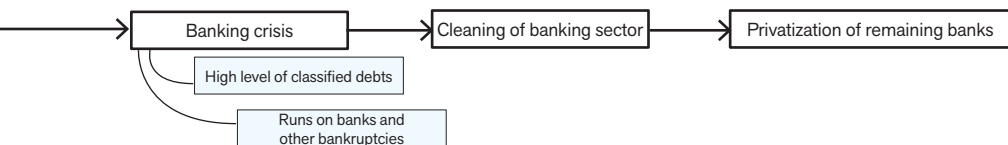
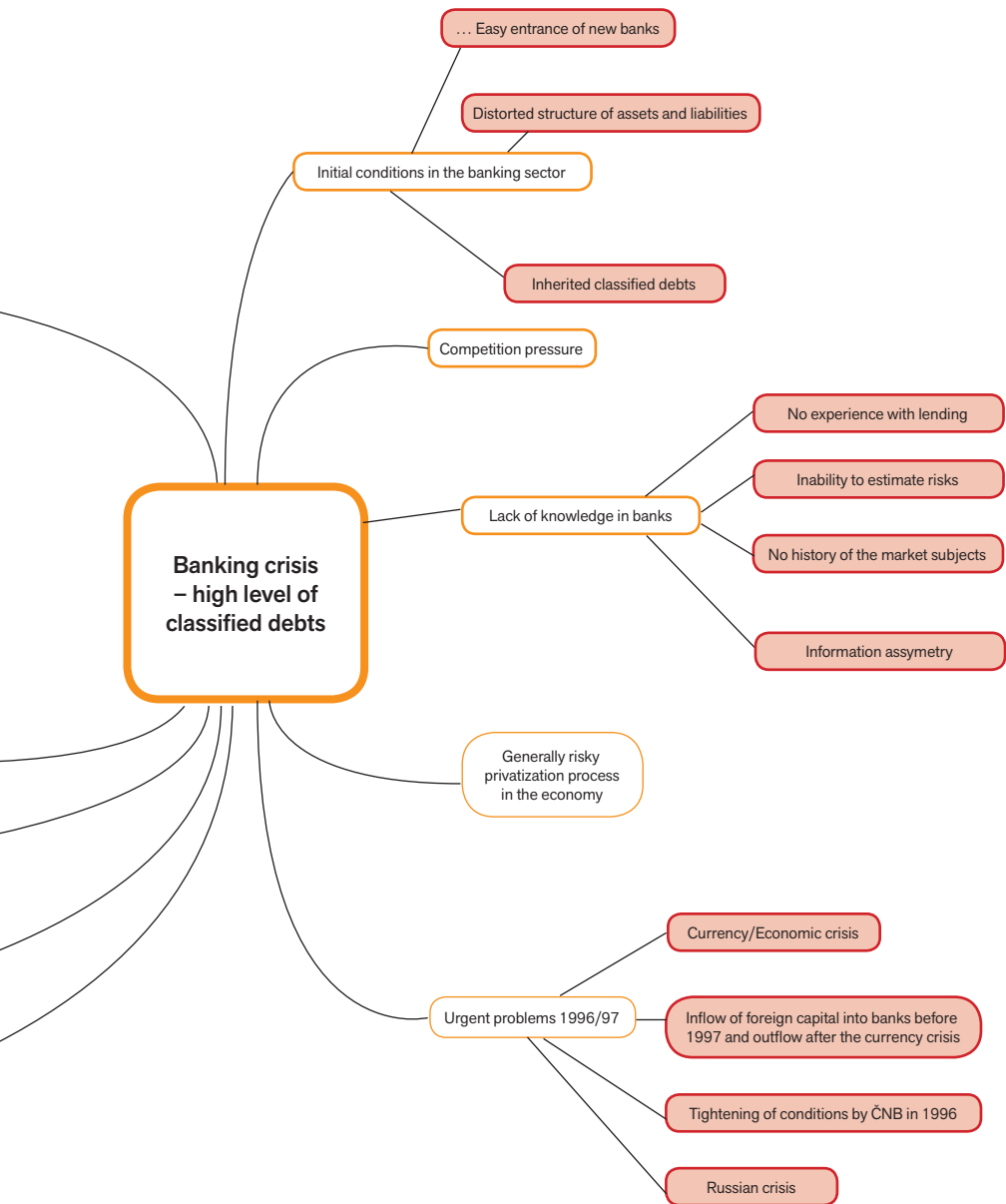
Increase interest rates

CB strives to rise attractiveness of holding local currency

Sales of foreign exchange reserves

CB strives to rise exchange rate of CZK – i.e. sells foreign currency in foreign exchange market and purchases local currency (CZK)





FROM CENTRAL PLANNING TO THE MARKET

”The book is clearly written and accessible to a broader public. It provides both the general explanations and a lot of useful information. An interesting book, especially regarding the former Czechoslovakia and then, the Czech Republic.”

—**Leszek Balcerowicz**, *professor of economics at the Warsaw School of Economics, former chairman of the National Bank of Poland, and former Deputy Prime Minister of Poland.*

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